
CONVERSATION 1

*Is an Independent Nonprofit Sector Prone to Failure?
Toward an Austrian School Interpretation of
Nonprofit and Voluntary Action*

Peter J. Boettke and David L. Prychitko

WITH COMMENTS BY

Zoltan J. Acs

Emily Chamlee-Wright

Roger Lohmann

Richard Stroup

Conversations on Philanthropy Volume I: Conceptual Foundations

®DonorsTrust
2004

CONTRIBUTORS

ZOLTAN J. ACS is the Doris and McCurdy Distinguished Professor of Entrepreneurship at the University of Baltimore. His research interests include the role of entrepreneurship in innovation, economic development and social and historical development. He is the author of twenty books including *Entrepreneurship, Geography and American Economic Growth*, Cambridge University Press 2005, and *Entrepreneurship and Philanthropy in American Capitalism, Small Business Economics*. He is the recipient of the Swedish award for Research on Small Business and Entrepreneurship in 2000, and the editor of *Small Business Economics*.

PETER J. BOETTKE is Professor of Economics at George Mason University, where he is also the Director of Graduate Studies and a Senior Research Fellow at the Mercatus Center. Boettke is the editor of the *Review of Austrian Economics*. He is also the author of numerous articles in the professional journals and has authored several books, including *The Political Economy of Soviet Socialism*, *Why Perestroika Failed*, and *Calculation and Coordination*.

EMILY CHAMLEE-WRIGHT is Associate Professor of Economics at Beloit College. She is author of *The Cultural Foundations of Economic Development* (Routledge 1997) and co-author of *Culture and Enterprise: The Development, Representation, and Morality of Business* (Routledge 2000) with Don Lavoie.

ROGER A. LOHMANN is Professor of Social Work and Benedum Distinguished Scholar at West Virginia University and the Editor of *Nonprofit Management and Leadership*. He is the author of numerous journal articles, and author of three books: *Breaking Even: Financial Management in Human Services*; *The Commons: New Perspectives on Nonprofit Organization, Voluntary Action and Philanthropy*; *Social Administration* (co-authored with Nancy Lohmann) and co-editor (also with Nancy Lohmann) of *Rural Social Work Practice*. He is the founder and operator of ARNOVA-L, CGAP-L, and 20 other electronic discussion lists. He is currently involved in creating a research and training center focused on sustained dialogue, public deliberation and other approaches to public talk.

DAVID L. PRYCHITKO is a professor of economics at Northern Michigan University and faculty affiliate in the Program on Markets and Institutions of the James M. Buchanan Center for Political Economy. Formerly a visiting fellow in the Program on Participation and Labor-Managed Systems at Cornell University, and Fulbright fellow at the University of Zagreb, he was most recently awarded the Green Honors Chair in Economics at Texas Christian University for 2003-2004. Prychitko has published widely in economics, and is the co-author (with Paul Heyne and Peter Boettke) of *The Economic Way of Thinking*, an introductory textbook published by Prentice Hall.

RICHARD STROUP is professor of economics and interim department head at Montana State University and a senior associate of the Property and Environment Research Center (PERC). During the Reagan administration, Stroup served as the director of the Office of Policy Analysis at the Department of Interior. He is a widely published author and speaker on economics, including natural resources and environmental issues. His books include the recent primer on economics, *Eco-Nomics: What Everyone Should Know About Economics and the Environment*, and a leading economics principles textbook, co-authored with James D. Gwartney, *Economics: Private and Public Choice*, now in its tenth edition.

IS AN INDEPENDENT NONPROFIT SECTOR

PRONE TO FAILURE?

TOWARD AN AUSTRIAN SCHOOL INTERPRETATION

OF NONPROFIT AND VOLUNTARY ACTION

Peter J. Boettke and David L. Prychitko

Introduction

Nonprofit organizations have traditionally been considered a legitimate alternative source for the services provided today primarily by the bureaucratic welfare state (Berger, Neuhaus, and Novak, 1996). Taken together, nonprofit organizations can be viewed as a vibrant but largely “independent” sector characterized by a spontaneous ordering of associations that are founded neither on the state’s compulsory power nor on the capitalist’s search for private monetary profit (Cornuelle, 1965). In an extensive body of work, however, Lester Salamon, one of the leading scholarly investigators of nonprofit organizations, questions the “independence” of the sector.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 or alternative source of services, Salamon sees nonprofits as being in an effective “partnership” with the state, a viable form of “third-party” governance. He argues that the independent sector is, in fact, not so independent, and that on its own it is prone to failure. Salamon points to the aftermath of the September 11th attacks as evidence:

Revealing though this episode has been of the remarkable strengths of America’s “third,” or nonprofit, sector, however, it simultaneously revealed the sector’s limitations as well. Private voluntary groups, though highly effective in mobilizing individuals to act, are far less equipped to structure the resulting activity. In short order, fragile systems of nonprof-

it response were severely challenged by the enormity of the crisis they confronted in the aftermath of September 11. Individual agencies, concerned about their autonomy, resisted efforts to coordinate their responses, either with each other or with government authorities. Individuals in need of assistance had to navigate a multitude of separate agencies, each with its own eligibility criteria and targeted forms of aid. Inevitably, delays and inequities occurred; many individuals fell through the slats, while others benefited from multiple sources of assistance. What is more, misunderstandings arose between donors, most of whom apparently intended their contributions to be used for immediate relief, and some agencies, most notably the Red Cross, that hoped to squirrel the funds away for longer-term recovery, general institutional support, and other, less visible, disasters down the road. What began as an inspiring demonstration of the power of America's charitable community thus became a demonstration of its shortcomings as well.

In this, the story of the nonprofit sector's response to the crisis of September 11 is emblematic of its position in American life more generally. Long celebrated as a fundamental part of the American heritage, America's nonprofit organizations have suffered from structural shortcomings that limit the role they play. This juxtaposition of strengths and limitations, in turn, has fueled a lively ideological contest over the extent to which we should rely on these institutions to handle critical public needs, with conservatives focusing laser-like on the sector's strengths and liberals often restricting their attention to its weaknesses instead. Through it all, though largely unheralded and perhaps unrecognized by either side, a classically American compromise has taken shape. This compromise was forged early in the nation's history, but it was broadened and solidified in the 1960s. Under it, nonprofit organizations in an ever-widening range of fields were made the beneficiaries of government support to provide a growing array of services—from health care to scientific research—that Americans wanted but were reluctant to have government directly provide. More than any other single factor, this government-nonprofit partnership is responsible for the growth of the nonprofit sector as we know it today. During the last twenty years, however, that compromise has come under considerable assault (2002a, 4-5).

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. Salamon's theory of third-party governance is recognizable as a species of postcommunist scholarship seeking new foundations for strong state action in social and economic planning. Much of today's postcommunist analysis—epitomized by the work of economist Joseph Stiglitz (1994), among others²—has turned not toward free and open markets but instead toward the market-based welfare state. Salamon's longstanding advocacy of "third-party government" strikingly resembles this postcommunist justification of the state and likewise relies on an economic critique. Salamon proposes that the rise and evolution of "third-party government" was missed, misinterpreted, or, worse, ignored outright by scholars, largely because of defective economic theory.

Salamon is not the only theorist of the nonprofit sector critical of the standard economic approach. In his intriguing work *The Commons: New Perspectives on Nonprofit Organizations and Voluntary Action*, Roger A. Lohmann (1992, 159-76) agrees that the standard theory fails to understand the nature of the nonprofit organization, but he argues this for reasons that differ substantially from Salamon's.

This paper outlines a critical assessment of the coherence of Salamon's paradigm from a largely Austrian economic perspective (that is, one in the tradition of Ludwig von Mises and F.A. Hayek), examines the potential for Lohmann's suggested revisions, and begins to explore how Austrian economic theory can advance our understanding of the social role of nonprofit voluntary organizations.

We shall proceed by first discussing the motivation behind Salamon's theoretical challenge, one that is rooted in a critique of Burton Weisbrod's economic analysis of nonprofits. We shall then discuss Salamon's attempt to rectify the shortcomings of the Weisbrod model. We shall also explore Lohmann's criticism of the economic theory of nonprofits, which encompasses the attempts by Weisbrod and Salamon. We argue that although some of Lohmann's criticisms are generally correct in spirit, his proposed revisions to mainstream economic analysis (such as his attempt to rectify the classical distinction between "productive" and "unproductive" labor) are unfortunate and can be better developed using the insights of Austrian economic theory. We conclude with a preliminary discussion of the political economy of the nonprofit sector in general.

A Salamonic Paradigm? Voluntary Failure and Third Party Government

First we must more clearly describe Salamon's approach. Again we will let Salamon's written words speak for him:

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” 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, 6).

“More than any other single factor,” Salamon contends, “this government-nonprofit partnership is responsible for the growth of the nonprofit sector as we know it today” (2002a, 5), and he has developed a wide reputation for a large body of empirical work that appears to support his theory.³

Salamon believes his theory provides a new “paradigm”—in the Kuhnian sense (1987, 36; cf. Salamon and Anheier 1996b, 1-7, 119-123)—to explain the evolution of the government-nonprofit partnership, and to justify and promote its continued development. Although the present authors do not share

Salamon's ideological perspective, our purpose here is not to engage in an argument over competing ideological visions.⁴ We wish instead to examine Salamon's paradigmatic theory. Salamon attempts to engage in nothing less than a theoretical reconstruction of economic analysis, specifically targeting the notions of market failure and government failure. To this mix he adds his new notion of “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 through the wrong theoretical lenses.⁵

The standard literature posits that nonprofit and philanthropic organizations arise in response to both market failures (due to free rider problems) and government failures (due to development of programs that meet the demands of the “majority” of constituents but leave unmet the demands of others).

Burton Weisbrod's thesis (1988, 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; in specific cases, however, particularly with respect to 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) the provision of public goods by employing its coercive powers to tax free riders (i.e., those who would enjoy consuming a public good but who have little or no incentive to voluntarily pay to obtain it).

Weisbrod suggests that government intervention of this nature 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, for example, of 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 is much more complex. Although it might be assumed that most “everybody” in the country enjoys at least a certain level of national defense, not “everybody” enjoys or rides for free on the services provided by Alcoholics Anonymous, the Muscular Dystrophy Association, the Sierra Club, or the Little Sisters of the Poor. While these services *might* display some characteristics of public goods (although

we aren't convinced of that), 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 prevent—if only unintentionally—the optimal production of these services. This shortcoming 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 place 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. They emerge as a “substitute” for state intervention in light of efficiency failures in the marketplace.⁶

Salamon (1987, 39; 1992, 125; Salamon and Anheier 1996, 9-10) criticizes Weisbrod for failing to acknowledge an empirically robust partnership between nonprofits and criticizes the state for failing to recognize that nonprofits and the state are not mere substitutes for each other but are in fact symbiotic complements. Salamon suggests that the existing partnership between nonprofits and the state simply cannot be explained or predicted in traditional analytical constructs. Rejecting Weisbrod, Salamon advances the claim that the partnership is fundamentally a response to inefficiencies in the “voluntary,” nonprofit 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, 43).⁷

At the core of Salamon's self-described paradigm are the notions of efficiency and its converse, inefficiency. By advancing claims that a set of institutions—market, voluntary, or government—are failing, Salamon's approach necessarily employs particular assumptions about the potential efficiency characteristics of those institutions. He needs some benchmark for success. Precisely what does Salamon mean when he speaks of voluntary-sector failure? Just how might nonprofits be inefficient, or how might they be deemed “inherently limited?” What scientific basis does Salamon provide which allows him to conclude that the merging or “partnership” between nonprofits and the welfare state are not only the *consequence* of voluntary sector failure but also an efficient *improvement* within that sector?

To be sure, Salamon recognizes that answers to these kinds of questions are “more conceptual than empirical” (1987, 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. Nevertheless, we believe (and can argue in detail) that Salamon fails to establish firmly the notion of voluntary-sector failure and the efficiency-enhancing role of the state among nonprofits. Salamon's ideological sentiments favor a robust linkage between nonprofits and the state, but we do not believe he has developed a consistent, positive theory that provides the kind of conceptual framework—a paradigm, in his words—that matches his ideological hope with empirical possibility. 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.

Weisbrod, Salamon, and most other commentators on the economics of the nonprofit sector draw upon welfare theory, a theoretical model in neoclassical economics that, in our estimation, cannot deliver the goods. This is a strong claim on our behalf, one which requires us to reexamine the standard economic analysis of “market failure.”

Success and Failure: A Lesson in Basic Economic Theory

What do economists mean when they say that a market “fails?” And what do they mean when they say that state intervention can alleviate market failure? What, if anything, does government failure mean in this context? Let's briefly examine the theory of market (and government) failure, for Salamon's case for the nonprofit-government partnership cannot be understood without some exposure to the alleged efficiency (and inefficiency) characteristics of markets.

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 better understand these concepts, we must first imagine an idealized economy in which all participants enjoy several limiting assumptions, including the following: full and complete information; zero transac-

tion costs; prices that they take as given (i.e., beyond any individual's or coalition's ability to manipulate). Standard economic analysis has established that individuals within this hypothetical economy will exercise the ability and the incentive to exchange goods and services freely, 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.⁸ 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 simultaneously achieve production efficiency (i.e., all least-cost technologies will be employed), exchange efficiency (all mutually beneficial gains from exchange will be exhausted), and product-mix efficiency (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 they are judging. Real-world markets, however, might not succeed in fully reaching this optimum.

Market failure, therefore, has a rather refined and specific meaning to economists. Market failure refers to cases where voluntary exchange fails to reach this Pareto-Optimal or "efficient" outcome. The production of a good that creates a negative externality, such as pollution, is a common example.⁹ The Weisbrod case for nonprofits focuses, however, on the potential for markets to generate *positive* externalities, and, more specifically, *public goods* problems. *Government failure* comes into play in the context of solving the problems associated with using state action to optimize delivery of public goods. While market failure means a failure of the voluntary exchange process to hit a purely hypothetical optimum, government failure, to be consistent, must mean a failure of the state to compel its citizens to act in ways such that the hypothetical optimum delivery of public goods is realized.

Weisbrod's work has the virtue of using the market failure concept correctly. It seems to us that he also uses the concept of government failure generally correctly. Relying on these concepts, Weisbrod views the nonprofit sector as a remedy for both market and government failure, especially in the delivery of highly diversified or 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, 25).

Our problem with this approach, and that of welfare theory in general, is the misplaced concreteness that too readily allows the confusion of economic models with reality. Even if problems of calculation and taxation could be solved in instances of homogeneous demand for certain goods (and we treat this hypothesis with enormous skepticism), there is simply no way that citizens, economists, policymakers, or anyone else can possibly know people's unexpressed "demands" in real, existing economies, *regardless* of whether we have *a priori* beliefs that those demands might be homogeneous for some goods and heterogeneous for others.¹⁰

How Does Any of This Relate to the Viability of the Nonprofit Sector?

If you have followed our outline thus far, you are probably asking that very question. The critical claim that Weisbrod makes is that 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 of these things. Neither he, nor any other economist, knows what the Pareto Optimal point is for *any* aspect of society. Hence, our approach to understanding the existence and action of nonprofit organizations seriously questions the value, and purpose, of the Pareto-Optimality benchmark that undergirds the market failure/government

failure analysis. This is not an argument against nonprofits. Indeed, if we are to arrive at a more vigorous and theoretically viable understanding of non-profit action, we must confront head-on the supposition that nonprofits emerge merely to make up for failures of the market and the state.

Salamon's Notion of Voluntary Failure

Salamon's new paradigm is critical of the market failure/government failure explanation of nonprofits, too, but for reasons fundamentally different from ours. He seeks not to radically question standard welfare theory, but to revise it to account for yet a *third* form of failure—that of the voluntary sector itself. Standard economists chatter a great deal about failure in the market and state sectors, but Salamon adds that if the voluntary or “third” sector is a significant parallel institutional sector, perhaps it, too, is prone to failure.

The project of proposing voluntary failure would seem to require, then, a careful adaptation of the standard welfare theory of “failure” in the context of the voluntary sector. Nevertheless, we haven't come across any mention of Pareto Optimality in Salamon's writing, negative or positive.¹¹ His case for voluntary failure, it appears, depends on the implications of data rather than theory. Salamon's 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, supported through compulsory state actions through subsidies and other measures. Salamon claims that this “partnership” remains a factual anomaly in the Weisbrod model. “Not only does this partnership have deep historical roots,” Salamon maintains, “it also has a strong theoretical rationale” (1989, 204). He goes so far as to say that this “partnership” was a “central organizing principle of the American welfare state” (1989, 205),¹² and he believes that these observations establish a sufficient theoretical explanation.

Salamon's case rests upon his concept of “voluntary failure” and, because he juxtaposes this concept against market and government failure, an implicit acceptance of Pareto Optimality. But he apparently misunderstands the objective of the government economic policy solution to the positive externality and public goods problem. 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, 41).

Salamon calls for a distinction between the case for government *taxation and funding* of goods associated with positive externalities and public-good characteristics and government *production* of those goods. Nevertheless, he fails sufficiently to distinguish funding from production. He observes a world where funding and production/delivery are often separate and labels that phenomenon “third-party government.” He then claims that standard welfare economics cannot conceptually explain this assignment of government function to external nonprofit institutions—hence the empirical “anomaly” he sets out to explain in his own theory. Unfortunately, Salamon shares a common but erroneous belief that the standard economist's case necessarily involves a combination of government funding and production.

James Buchanan, in one of the landmark works on the subject, stated clearly that funding and production of public goods can be legitimately separate functions:

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, 186).¹³

Salamon's hope to explain "third-party government" with a new paradigm—one that can finally begin to account for this "anomaly" of government funding and third-party production/delivery of public goods (in other places, he calls it an aberration [1995, 6])—is without theoretical support. 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. Instead, standard analysis typically suggests that the government can improve the efficiency of the market by forcing free riders to pay, through taxes, for the goods that they enjoy. The specific organization of production—a matter of 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 interpretation of nonprofit production of public goods as an extension of legitimate functions of government is an unfortunate misunderstanding of basic economic theory, and it leads him to misinterpret the implications of the data.

Now, that in itself doesn't require us to reject entirely Salamon's concept of "voluntary failure." The standard "paradigm," as it were, has already accounted for and explained nongovernment 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, however, Salamon's "voluntary failure" concept can be fitted into the standard analysis, and thereby clarify and shore up the normative defense of government-nonprofit collaboration that he has tried to develop over the years.

Salamon advances claims that the voluntary sector is "inherently" limited, that it will likely offer services that "will be less than those society considers optimal," and that 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 speak meaningfully of a "voluntary failure" to generate 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 of success that is consistent with the other two failure concepts. But Salamon develops nothing of the kind, in his 1987 paper or after. He instead depends upon a tremendous amount of empirical work to justify his theoretical conclusion that third-party government is a reasonable arrangement in light of market, government, and voluntary failure.

Here we would reiterate our observation that the entire welfare economics framework is flawed with unrealistic assumptions as well as with unrealizable goals and expectations for policymakers and government bureaucrats. Adding the voluntary-sector failure concept does not noticeably improve the theory. Some of the criticisms made by Roger Lohmann seem to be on point here, and we shall turn to his account shortly. In our view, the Pareto framework in general, and the effort of Weisbrod to apply it to nonprofits in particular, is an example of misplaced concreteness. Weisbrod's effort and those of mainstream economists in this regard have at least the "virtue" of clearly articulating at the purely conceptual, theoretical level what optimality and failure mean. Salamon's effort only muddies the waters.

Salamon accepts in principle the notions of market failure and social optimality and advances claims that "third-party government" can propel the for-profit and nonprofit sectors toward a socially optimal outcome. However, he has not clearly articulated what he means by the concepts of optimality and failure. If he has the Pareto-Optimal criteria in mind, then he hasn't made any effort to demonstrate that the modern welfare state's funding of nonprofit services has propelled our system closer toward the socially optimal outcome. None of his empirical work has demonstrated, nor can it demonstrate, that a government-nonprofit partnership is closer to, farther from, or at a social optimum; nor has his work demonstrated that the disentangling of the wonderful panoply of nonprofits away from the state (a more recent development he laments) has pulled the system farther away from the socially optimal result. Salamon's addition to welfare theory—the concept of voluntary failure—has not demonstrated that the nonprofit sector fails to reach Pareto Optimality. Nor, toward an equally important goal, has this concept explained how the partnership between the nonprofit sector and the state can, even in pure theory, bring us closer to the Pareto Optimum. He makes these kinds of claims without introducing a methodology to provide either clear theoretical or empirical measures of the social optimum.

Perhaps Salamon has not offered a theoretical demonstration because he doesn't accept the Pareto-Optimal criteria. He may have a completely different understanding of what a socially optimal outcome means—but that does not square with his acceptance of the standard “market failure” concept. In addition, it clearly raises the obvious question of 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 in asserting that the “real answer” to the questions that he seeks to address in his body of research is “more conceptual than empirical,” but the bulk of his work since formulating his theory has been predominantly empirical, guided by his concept of voluntary failure. If his conceptual framework is, as we argue, flawed, then his selection and interpretation of the empirical data are also in question. On this point we find additional support in Smith (2000).

Toward an Alternative Theory: Lohmann on the Commons

We have thus far questioned both the knowledge assumptions and the theoretical coherence of the “failure project.” Roger A. Lohmann (1992, 159-160) also questions the failure theories of Salamon and Weisbrod, and the economic theory of the nonprofit sector in general, on the basis of the model's assumptions. His criticism differs from what we have provided so far, and his proposed alternative reformulation of the theory is worth exploring.

While our criticism focuses on assumptions regarding the knowledge available to both citizens and to the economic theorists developing real-world “solutions” to less than Pareto-Optimal outcomes, Lohmann criticizes the failure project for apparently grafting a theory of narrow self-interest and profit-seeking onto a social domain that substantially differs from commercial market activity. This domain still claims no universally accepted defining terminology: although “nonprofit sector” is a common usage, Richard Cournelle (1965) first proposed that it might be called the “independent sector,” Salamon calls it the “voluntary sector,” and Lohmann himself refers to it as “the commons.”¹⁴ Lohmann's effort to rename and create a distinct theoretical space for the sector is important: while assumptions that individuals pursue narrow self-interests might be suit-

able for the study of competitive commercial activity (the for-profit sector), Lohmann stresses—correctly in our view—that human action in general is not exclusively of the narrow, self-interested variety stereotypically ascribed to *homo economicus*. “The calculus of costs and benefits,” Lohmann laments, “has become a universal index to what is rational” (1992, 15). Lohmann asserts that rationality is much richer: “The pursuit of common goods is rational behavior, albeit distinguishable from the self-interested pursuit of profit that characterizes markets” (1992, 272-73). Reducing rationality to an overly restricted view of rational choice and calculative utility or profit maximization leads, at best, to an economic theory that treats nonprofits “as if” they were for-profit firms (1992, 16, 38), which, of course, “in the process dissolve[s] the very thing that is to be explained” (1992, 129). This logic is remarkably similar to the critiques of standard economic theory of perfect competition made by F. A. Hayek and Ronald Coase: if we assume for-profit firms act “as if” they faced perfect and complete information and zero transaction costs, we dissolve any reason for for-profit firms to exist at all. Lohmann likewise observes that the standard approach of economists leads to contradictions in market theory and also systematically underrates the potential efficiency of nonprofits compared to the ideal efficiency characteristics of competitive, for-profit firms:

This particular construction of the theory of nonprofit organizations begins with the critical assumption that nonprofits are a flawed or incomplete form of for-profit organization. Advocates of this position tend to assume, based on the absence of a consistent performance measure, that nonprofit organizations as a class are inherently more inefficient in the conduct of their affairs than comparable for-profit organizations (1992, 26).

Lohmann proposes that a theory of nonprofits ought to understand more clearly the interactive nature of individuals organized in nonprofit associations rather than “treat them as rather odd, intangible, and inefficient forms of productive enterprise” (1992, 164), for those are evaluative categories that are not so much the conclusions of careful research as they are biases already embedded into the theory's starting assumptions. *Homo economicus* would rarely find value in establishing or joining nonprofits unless, perhaps, he had something up his sleeve!¹⁵

We appreciate and agree with Lohmann's call for movement beyond the narrow neoclassical modeling of nonprofits. He believes that “some of the independent research efforts and work in nontraditional disciplines may have

major implications for the rethinking of nonprofit studies” (1992, 8), and that “it is unlikely that these conceptual problems can be resolved within economics alone” (1992, 39). Lohmann’s work is refreshingly eclectic, and draws from the theories of meaningful action found in Max Weber and Alfred Schutz (1992, 47-48), the hermeneutics of Hans-Georg Gadamer and Richard Bernstein (1992, 262), and Kenneth Boulding’s call for an economic analysis that can account for the motives of love and fear, as opposed to a purely utility-maximizing calculus (1992, 170). As two (outlier) economists who have been inspired by the work of all of these individuals and have tried to draw their work into Austrian economic theory, we must admit we have a modest bias toward Lohmann’s efforts.¹⁶ That said, we find that Lohmann unfortunately wishes to resurrect some other fundamentally flawed assumptions of classical economic theory. In other words, he falls short not by pointing toward non-economic social theories, but instead by a peculiar return to classical economic theory. Once again we will see that a critical stumbling block for nonprofit theory exists in our understanding of the organization of production by nonprofit firms.

Is Unproductive Labor Common in the Commons?

Lohmann puts it the following way:

An adequate economic model for analysis of the commons ought to begin by studying actual economic institutions, like donations and endowments, and by adjusting or suspending three conventional economic assumptions: scarcity, production, and maximization. The economics of common goods does not require rejecting the concept of scarcity entirely. However, acknowledgment of the moral and rational consequences of affluence or social surplus is important (1992, 160-61).

Lohmann supports what he calls “existential” scarcity—basically, the universal fact that people must choose, as wants exceed what is available (1992, 161). So far, so good. That’s what all economists mean (or should mean) by the term. He questions the role of models wedded exclusively to maximization (1992, 163), and suggests the concept should lose its “privileged position” as a universal approach to social action. We generally agree with him here, too.¹⁷ He slips a bit—as many non-economists do—with his use of the term *surplus*, but our concern is chiefly with his use of the term *production*.

Harkening back to Adam Smith’s *Wealth of Nations*, Lohmann writes, Nonprofit economics grounded in failure theory treats nonprofit organizations by analogy with (as if they were) the profit-oriented firms of microeconomics... Adam Smith’s distinction between productive and unproductive labor...is ignored or overturned in the contemporary concept of volunteer labor [cites Weisbrod]. Such an approach is defensible in the analysis of revenue-generating nonprofit firms like hospitals; nursing homes; and some museums, theaters and concert halls, where clear-cut prices are exchanged for recognizable products. However, the rationale for treating “unproductive” (non-revenue) membership clubs; donative charities; and a broad range of other religious, scientific, or artistic commons as if they were commercial firms is highly questionable. Yet because of the widespread commitment of nonprofit economics to the market firm analogy, no other economic models of the commons have received serious consideration. *A major project confronting nonprofit and voluntary action researchers, therefore, is to begin the construction of a genuine economics of common goods premised on more plausible and relevant assumptions* (1992, 160; our emphasis).

We agree especially with Lohmann’s last point. The instrumental nature of mainstream economic theory is not concerned with the descriptive realism of its assumptions, but focuses economists on their ability to make accurate predictions. Lohmann’s argument suggests that instrumentalism has largely run its course—at least with regard to nonprofits—and, moreover, proceeds with biases that cast doubt on the viability and value of nonprofits before the research is undertaken.

Despite our agreement with the central thrust of this critique, we are troubled by Lohmann’s appeal to Adam Smith. Is Smith’s distinction between productive and unproductive labor something that a new economic approach to nonprofits ought to reconsider? It, and Smith’s corresponding definition of wealth, have been sources of discussion in the nonprofit literature, including the work of Severyn Bruyn (1991, 322-325), who laments that Smith denigrated the service sector and created a strictly material notion of wealth that he believes haunts us to this day.¹⁸

Smith, and the early classical in general, confined “wealth” to material goods production.¹⁹ Smith differentiated material goods from services, and argued, if only as an analytical convenience, that labor used to produce mate-

rial goods was categorically different from labor employed for services. For Smith, labor is *productive* if it increases the output of material goods (wealth); it is *unproductive* if it only provides services.²⁰ Productive labor is that which creates vendible commodities.

Lohmann supports Smith's distinction because he believes that the mainstream economics literature "equates all types of human behavior with production," which he believes "must be explicitly rejected in the case of the commons" (1992, 162). Regrettably, in our opinion, he embraces Smith's distinction and argues that because nonprofits are not producing vendible commodities (recall, nonprofits, as we are using the term, don't produce anything for sale on the market), the labor involved in nonprofit associations (the commons) is "unproductive" and therefore not amenable to standard profit-maximization analysis. In other words, it's a fundamentally different category of labor that can't be pigeonholed into the standard maximization model. It is, using Smith's term, *unproductive* labor. For Lohmann, the neoclassical treatment continues to ignore this crucial distinction, which may prove to be a good point at which to begin developing a more coherent theory of production of nonprofit "goods."

The Austrian Contribution

In our view, returning to Smith's distinction between productive and unproductive labor won't help us differentiate the purpose of for-profit firms from nonprofit activity. There is of course a peculiar irony, if we follow Lohmann, that the promotion of the nonprofit sector would imply the exalting of "unproductive" labor, when, in fact, such services can be remarkably productive. But more importantly, we believe that the distinction between "productive" and "unproductive" labor makes absolutely no sense. This is precisely where an Austrian understanding of wealth, production, and ultimately calculation can contribute to the development of an alternative theory of nonprofits such as Lohmann, Salamon, and others seek.

What is wealth?

In its broadest sense, wealth is simply *anything* that a person values. Smith and the classicals developed an economic theory to try to explain material wealth, which led them to make the distinction between labor that

produces material things—vendible commodities—and labor that produces services. By contrast, the subjective theory of value articulated by Austrian economists holds that wealth is whatever a person strives for: it consists not only of material things (from food, water, and shelter to fast cars, video games, and money), but also of nonmaterial goods (such as love, respect, intelligence, historic preservation, beauty, and so forth). As we have stated elsewhere (Heyne, Boettke, and Prychitko 2003, 18), equating wealth strictly with material things makes no sense in a theory of choice, and must be rejected at its root.

What is production?

In simplest terms, production is the creation of wealth, the creation of anything we value. Of course, we typically picture the construction of new buildings, roads, bridges, and the like as productive activities. New things—new human artifacts—have been created. But production is not to be limited to the production of new things. Simple acts of trading already-produced items (as in barter, for example) are productive because they increase the wealth of both trading parties. Each individual in a voluntary trade sacrifices something they value for something they value more highly. Each individual gains (or, at least expects to gain) more by engaging in the exchange; otherwise, it would not be voluntarily undertaken. Most modern economists have this understanding of wealth and production in mind, even if they tend to focus largely on the production of material wealth (see Heyne, Boettke, and Prychitko 2003, 17-20).

Why doesn't the productive/unproductive labor distinction make sense?

The restriction of wealth to material things as a result of the differentiation of productive and unproductive labor is simply too limiting. Ludwig von Mises stated this clearly in his 1933 work, *Epistemological Problems in Economics*:

Because the classical economists were able to explain only the action of businessmen and were helpless in the face of everything that went beyond it, their thinking was oriented toward bookkeeping, the supreme expression of the rationality of the businessman (but not that of the consumer). Whatever cannot be entered into the businessman's accounts they were unable to accommodate in their theory. This explains several of their ideas—for example, their position in regard to personal services. The performance of a service which caused no

increase in value that could be explained in the ledger of the businessman had to appear to them as unproductive. Only thus can it be explained why they regarded the attainment of the greatest monetary profit possible as the goal of economic action. Because of the difficulties occasioned by the paradox of value, they were unable to find a bridge from the realization, which they owed to utilitarianism, that the goal of action is an increase of pleasure and a decrease of pain, to the theory of value and price. Therefore, they were unable to comprehend any change in well-being that cannot be valued in money in the account books of the businessman (1981, 175).

[W]ith the scheme of the *homo economicus* classical economics comprehended only one side of man—the economic, materialistic side. It observed him only as a man engaged in business, not as a consumer of economic goods (1981, 180).

Mises argued that economics, as a theory of choice, cannot restrict itself to the calculative rationality personified by businesspeople—call it simply *homo economicus*—and claim universal applicability. Mises called for a *praxeology* (1981, 180), a general theory of choice that does not succumb to distinguishing choice in a heterogeneous way, and later attempted a full-blown praxeological theory (1966).

What is Calculation?

One of Mises's greatest achievements was in developing a theory of economic calculation. In the Austrian tradition, calculation has a highly refined meaning. It is not merely measurement, as in some input-output flow chart. After all, Soviet planners could measure how much land, labor, fertilizer, tractors, and so on it took to produce a ton of wheat on the collective farms. But they couldn't calculate the added value of that effort to determine whether they had used those resources efficiently and productively. Lacking market-generated prices, they had no way of solving, with Mises, "the task of allocating [scarce resources] to those employments in which they can render the best service" (1966, 207). They couldn't determine whether or not their production plans were worth the cost—whether they generated a positive net improvement in wealth. This makes for an economic and social disaster, for the efforts of planners *can't* coincide with the interests of the socialist system's citizens. They lack the knowledge to plan the economy successfully because they lack the ability to calculate.

Measurable data—call it simply information—does not in itself allow for rational economic calculation, as Mises employs the term. In fact, he goes so far as to say, "the distinctive mark of economic calculation is that it is neither based upon nor related to anything which could be characterized as measurement" (1966, 209). This sounds strange, but Mises argues that measurement implies a fixed unit of measure (say, the length of a yardstick), but calculation requires market-generated prices, and prices themselves are not immutable units; they change over time, whereas a yardstick doesn't.

This language can be confusing to non-economists, so we shall forgo any lengthy discussion and jump to the bottom line: economic calculation, as Mises and Austrian economists in general use the term, is only possible with monetary prices established in markets. Calculation of profit (or loss)—the residual or added monetary value of a firm's activity—can be determined only by market prices. Mises insists that "money prices are the only vehicle of economic calculation" (1966, 201; also see 208-209, 229).

Exactly what is calculated?

Mises further insists that "Monetary calculation is not the calculation, and certainly not the measurement, of value" (1981, 160). Monetary calculation allows decision makers—say, for-profit entrepreneurs—to calculate the expected monetary *residual* of their efforts, the total revenues from the total costs of their efforts. It also allows them to assess after the fact whether their expectations were realized (in the form of a monetary profit or loss). Monetary calculation does not generate an objective measure of value—for value, in an economic theory of choice, resides in the eyes of the choosers (though, admittedly, it can have an intersubjective dimension).

Can not-for-profit organizations calculate?

Hence, the dependence of calculation upon market-generated prices does not necessarily handicap not-for-profit firms. Recall our distinction between nonprofit organizations and not-for-profit firms. Not-for-profit firms face market prices for their inputs, and charge a market price for their service or product. As long as their inputs and outputs are priced through the voluntary exchange of providers and recipients (a "market mechanism," as it were), the expected residual (or profit, distribution issues aside) can be calculated, as well as the realized residual (the actual profit or loss).

For these kinds of not-for-profit organizations—ones that price their services—calculation can and does occur. Perhaps this is why Lohmann places them outside the realm he calls the commons. The donors can receive, in principle, a calculative measure of the (monetary) value added that occurs, or fails to occur, in specific not-for-profit organizations, and therefore have a guide for framing their grant-making choices.²¹

Most noncommercial voluntary organizations, however, do not calculate.

And *here's* what Lohmann is really trying to point out. Voluntary non-profit organizations and associations may, and surely do, purchase or lease inputs on the market, and are therefore guided by prices at that stage, but they don't price their "product" or service (however they define it). They engage in unilateral transfers, providing a scarce service to others without the exchange of money (or any other commodity, for that matter) in return (Boulding 1981, ch. 1). They do have access to market processes (and, of course, political processes). Being "in" the commons does not imply they are divorced from other social institutions and processes. Yet, although non-profits can undertake *measurements*, and, if encouraged, a rational assessment of their outcomes (using both quantitative and qualitative means), they have no way of calculating the realized results against the expected results. Nonprofit organizations and associations cannot, in other words, calculate the residual or monetary value-added of their endeavor, *ex ante* or *ex post*. In this sense, *nonprofit* is a better term for those that don't price their service or product. There is *no* calculated monetary profit.

We suggest that the distinction between calculative and noncalculative action is more productive, as it were, than Smith's distinction between productive and unproductive labor. But there remains a troublesome aspect of these kinds of nonprofits in the very fact that calculation does not and cannot exist. The absence of such calculation implies that entrepreneurs who create and executives who manage nonprofit firms may indeed be handicapped in their ability to demonstrate the efficiency or inefficiency of their activities. If we stick with Mises's definition and understanding of calculation—which we want to do—there is either calculation or there isn't. There are no "proxies for calculation": issues of trust, reputation, satisfaction, and so on might serve as effective guides to action, but they cannot serve as sources for calculation itself. Market prices are a necessary and sufficient

institution that allows for calculation (although inflation can severely distort that role). Pseudo-calculation means, in effect, no calculation, in the Austrian perspective. Without a priced service, the agents of nonprofit organizations and their donors might engage in pseudo-calculation, but let's understand that really means no calculation. We suggest it would be vain for theorists or practitioners to try to discover or invent some kind of pseudo-calculative proxy for price and thereby claim that they have "solved the calculation problem" in the nonprofit sector. This also implies that the search for a calculation of "social wealth," "social return on investment," or even a standard measurement, is problematic.²²

Does this problem imply that the largest set of nonprofit firms are prone to coordination failure?

Salamon, of course, has his own answer to this question, related to his use of the voluntary failure concept. As we have declared above, however, we believe that applying notions of failure, which are by definition linked to concepts of economic efficiency, creates a problematic and misleading approach to a theory of nonprofit activity.

We recognize that at first blush our suggestion that individuals in nonprofit organizations are engaged more in a noncalculative activity might be troublesome for economists who consider calculation to be a necessary condition for rational and effective human activity. In a sense, when studying the nonprofit sector we are moving from the domain of economics (and calculation) to the broader realm of praxeology, the general theory of human action, as Mises himself distinguished these terms (1966, 234). This avoidance of reductionism is what Lohmann really has in mind, and justifiably so. Mises argues that economics is the subset of praxeology that deals with calculative action (1966, 199), but he affirms that not all human action is "economic" and calculative (1966, 231). When we consider the nonprofit sector, we are moving in part into that realm of human action that straightforward economic theory, with its emphasis on calculation, can't quite capture. Economics is, Mises insists, the most elaborated subset of a more general theory of human action (1966, 3). But economic calculation is not *synonymous* with rational human action. It is one terribly important *kind* of rational action that evolves with commercial society, but it would be a great mistake to claim that only calculative action engenders rational, coordinating properties.

The following statements by Mises (1966, 214-15), which we shall quote at length, should help clarify what's at stake in our exploration of the non-profit sector (we interject in brackets where we deem it helpful):

Economic calculation cannot comprehend things, which [like the services of nonprofits] are not sold and bought against money.

There are things which are not for sale and for whose acquisition sacrifices other than money and money's worth must be expended. He who wants to train himself for great achievements must employ many means, some of which may require expenditure of money. But the essential things to be devoted to such an endeavor are not purchasable. Honor, virtue, glory, and likewise vigor, health, and life itself play a role in action both as means and as ends, but they do not enter into economic calculation.

There are things which cannot at all be evaluated in money, there are other things which can be appraised in money only with regard to a fraction of the value assigned to them. The appraisal of an old building must disregard its artistic and historical eminence *so far* as [our emphasis] these qualities are not a source of proceeds in money goods vendible. What touches a man's heart only and does not induce other people to make sacrifices for its attainment remains outside the pale of economic calculation.

However, all this does not in the least impair the usefulness of economic calculation. Those things which do not enter into the items of accountancy and calculation are either ends or goods of the first order. No calculation is required to acknowledge them fully and make due allowance to them. All that acting man needs in order to make his choice is to contrast them with the total amount of costs their acquisition or preservation requires. [And here Mises turns to a rather remarkable example.] Let us assume that a town council has to decide between two water supply projects. One of them implies the demolition of a historical landmark, while the other at the cost of an increase in money expenditure spares this landmark. The fact that the feelings which recommend the conservation of the monument cannot be estimated in a sum of money does not in any way impede the councilmen's decision. The values that are not reflected in any monetary exchange ratio are, on the contrary, by this very fact lifted into a particular position which makes the decision rather easier [yes, *easier!*]. No complaint is less justified than the lamentation that the computation methods of the market do not comprehend things not vendible. Moral and

aesthetic values do not suffer any damage on account of this fact.

Mises's acknowledgement that calculation is not required to make a rational decision to spare the town landmark hits the heart of the issue. Nonprofits are not isolated islands of human activity within the voluntary sector—the commons. Like another institution, the family, participants in nonprofits are themselves embedded in the institutional matrix of the market economy. Nonprofits have prices to guide them, particularly when purchasing or leasing inputs. In this way they can coordinate their resource demands with the supplies of resource providers, and they can and do participate in the knowledge-disseminating features of the market process. Although they cannot calculate the value added of their efforts, they can determine whether their specific goals and efforts are worthwhile. Nonprofits have to persuade prospective donors that their effort is worthwhile, of course. Rather than persuade them with the lure or calculated signal of monetary profit, however, they must turn to noncalculative but measurable or assessable means. The lack of economic calculation does not in itself create any impediment to coordination. Likewise, there can be no theoretically sustainable notion of “voluntary failure” such as that proposed by Salamon. The objection might be made, however, that application of a subjective theory of value as proposed here cannot help produce overall efficient allocation of philanthropic resources (or of tax-generated resources for welfare). Here, more broad accomplishment of plan fulfillment must suffice in the necessary absence of some more comprehensive yet undefinable and unattainable standard of social optimality. Even against the Pareto standard, there is little justification for criticizing nonprofit firms as failing in terms of efficiency.

We suggest that the managers of nonprofits, “social entrepreneurs,” and their donors are able to make rational decisions about the effectiveness of their activities even though they cannot calculate the value added in a monetary sense—calculation being, again, a dollar measure of the total costs of their efforts and the total benefits of their efforts, the difference being monetary profit (or loss).²³ We would add that they would have a greater incentive than government officials to assess effectiveness, because unlike Mises's councilmen they cannot rely upon the power to tax. Instead, they must depend upon the voluntary contributions of their donors. This, of course, is problematic in our society, where many nonprofits often bypass the responsibility of persuasion and voluntary exchange and instead seek support from

the state (not unlike many private business enterprises). In this regard, to accept Salamon's advocacy of third-party government, which in effect seeks to legitimate nonprofit firms as arms of state action, would further weaken the effectiveness of nonprofit organizations by encouraging them to engage more in political rent-seeking than in marketplace persuasion.

The Bigger Picture: Governance and the Nonprofit Sector

With Lohmann, we believe that the nonprofit sector is viable and, we should add, productive. But we think Lohmann's appeal to the distinction between productive and unproductive labor as a central theoretical premise should be jettisoned in favor of the Austrian distinction between calculative and noncalculative rationality. This leads us back to the normative issue of whether the commons should be a largely independent sector, or whether its "partnership" with the state is a promising development.

Independence and Constitutional Constraint

A promising 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 considers so anomalous in standard economics. As we argued above, this distinction 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 simultaneously empower the protective and productive state while constraining the redistributive state through constitutional construction. The problem, of course, is whether such a balancing act can indeed ever 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 taxation power to benefit some at the expense of others.

Kenneth Boulding (1969, 482) recognized that "the private grants econo-

my may be justified primarily in terms of it being a check or countervailing power to the public grants economy." Salamon fails to appreciate Buchanan's concerns and Boulding's insight—in part, we believe, because his new "paradigm" doesn't take sufficient account of the unintended consequences of human action.

In a genuinely free society, the voluntary sector should play a critical role in reinforcing the constitutional constraints that limit government to those activities, and only those activities, to which it has a reasonable claim to engage and use its coercive power of taxation and monopoly provision. Granted, this is not the intended 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 can—as an unintended consequence—function to reinforce constitutional constraints on the state simply by providing goods and services without state involvement or intervention. And it is this unplanned, though fertile, feature of the voluntary sector in a free society that is ignored by standard analysis, and by Salamon's approach, despite the fact that it was observed by Alexis de Tocqueville prior to the growth of the modern welfare state.

Many people misunderstand the argument made by economists such as Buchanan, Friedman, and Hayek concerning the role of government. Such "libertarian" economists are typically less concerned with the scale of government than the scope of government. Of course, the absolute size of government can be a concern, given fiscal realities, but the primary concern of these economists is the activities government attempts to tackle. There are activities in which government should not be involved 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 of news services, but the majority have not objected to government financing and provision of educational services (a consent now being reexamined by a burgeoning school choice movement). 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, moreover, ceases to serve this function—and loses the capacity to do so—when organizations within it partner with the coercive powers of the state. At that point, neither government nor market shortcomings can be overcome by this “third sector” because, instead, nonprofit organizations are transformed into rent-seeking entities dependent on tax finance rather than the voluntary contributions of individual donors. As client-partners of the state, many contemporary not-for-profit and nonprofit organizations provide goods and services, but no longer sustain the necessary feedback and disciplinary mechanisms to ensure that good intentions are channeled in directions that generate desired results. In the absence of both calculation and other measures of program effectiveness, modern nonprofits rely increasingly on political effectiveness, which inherently weakens their independent character. This shortchanges society of the valuable information and learning that should arise from independent nonprofit institutions.

Institutions and information

Hayek’s work encourages readers to consider the capacity of people to learn 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. In social interactions, of course, human intentions do not automatically equal the realized results; thus, in economic analysis, a results orientation must trump considerations of intent and moral intuition. Actors must be disciplined to align their behavior with desired outcomes, and they must be continually informed about how best to do so. In a for-profit setting, actors receive signals through the price system, helping them align their incentives and actions appropriately. In the political setting of democratic politics, political actors are disciplined—in theory, at least—through the vote mechanism. In an independent 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 striving to explain the coordinating properties of the sector.²⁴

Like the nonprofit sector, politics does not work as smoothly as theory might predict. The vote mechanism is not as effective at disciplining politicians as we might like, 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 the gap left by government and the market. But again, the voluntary sector can only serve this role if it abstains from or is denied the use of tax-derived resources.

Cooperation and Competition

Hayek (1979), building on the work of Cornuelle (1965), argues that an independent nonprofit sector has great potential for ensuring social cooperation by mobilizing individuals to work to improve the community environment; health, education, and work opportunities; and even the basic codes of conduct we rely on in our daily intercourse. Ironically, Cornuelle contends that as the voluntary sector gained the power to accomplish more things thanks 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 the finance and provision of those services done by the government, but also to challenge its monopoly on their provision.²⁵

It may indeed be true 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 for coupling government finance and provision, let alone for giving the government 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, 56). As such, even when it has been established that the government should finance and produce a particular good or service, the claim of the state to be a monopoly provider—or the sole source of financial underwriting for such services—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, 59).

Competition, whether in the for-profit market setting or among 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 coordinate their plans further. We suggest, with Hayek, that monopoly privilege and the coercive power to tax in order 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. Markets free of excessive government resources and intervention and an independent voluntary sector are better vehicles for promoting learning and social coordination.

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 and social 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" (Hayek, 1979, 53).

We suggest, then, that the sort of "third party government" advocated by Salamon would distort the incentives for nonprofit innovation and weaken the ability of philanthropists and social entrepreneurs to fill in the gaps that might be left by for-profit firms before government bureaucracies expand to fill the supposed vacuum. A persistent lack of conceptual clarity cascades into a theoretical confusion over the nature of this sector, a confusion that might also color the way Salamon and others read the empirical data. Ultimately, government-nonprofit partnership will not invigorate the voluntary sector but instead will enervate it. Lohmann's approach provides a glimpse of the direction we might head, and we believe that further exploration of the field from an Austrian perspective will advance our understanding of the complex, fertile role of the voluntary sector in promoting human excellence, by offering the information necessary for both individual plan fulfillment and social cooperation.

NOTES

- ¹ See, for example, Salamon (1981, 1987, 1989, 1992, 1993, 1995, 1999, 2002a), 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 theory of government-nonprofit partnership, one which continues to influence his most recent work.
- 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.
- ³ Recently, the methodology behind Salamon's empirical research has been strongly challenged by Smith (2000, 42-49).
- ⁴ 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, 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.
- ⁵ Salamon seems unaware of Boulding's work (1981), which is not founded on the market failure/government failure analysis. Boulding was a former professor of ours in the 1980s, and his work, particularly on knowledge transmission processes, fits nicely in the Austrian tradition.
- ⁶ In a recent paper, Glaeser and Shleifer (1998) explore the question of when entrepreneurs may decide to enter the market 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-inter-

ested entrepreneur will opt to enter as a not-for-profit entity.

- ⁷ Salamon's terms can be 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, if one is 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 on coercion. Finally, his term "third-party government" has nothing to do with political parties. It is, rather, merely 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, 19). He also does not clearly distinguish nonprofit associations from not-for-profit firms. The importance of a clear distinction will be discussed in a later section.
- ⁸ 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 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 costs \$3.00. At this point, there is no longer room for mutually beneficial trade. Other things being constant, any given consumer would value *one more* loaf of bread less than \$3.00; and any given baker could produce *one more* loaf of bread only at a cost higher than \$3.00, so all bargaining possibilities have been fully exhausted.
- ⁹ 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.

- ¹⁰ See Boulding's "The Economics of Knowledge and the Knowledge of Economics" in Boulding (1966) and Hayek's "Economics and Knowledge" and "The Use of Knowledge in Society," in Hayek (1948, 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, 323-43) and Wagner (1996).
- ¹¹ Although 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, 48). It is completely unclear precisely what "optimal" or "adequate" means in his new paradigm.
- ¹² Salamon regrets that, during the Reagan years, this structure began 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, 121-22).

¹³ Buchanan's point became conventional textbook material on the theory of public goods, available long before Salamon embarked upon a new paradigm. Thus Jack Hirshleifer (1980, 542) writes,

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).

¹⁴ "The term *commons* as used in this book may refer to a club or membership organization; social movement; political party, religious, artistic, scientific, or athletic society; support group; network; conference of volunteers; or to several other forms of what we think of as nonprofit or voluntary social organization. As developed here, the term is an ideal type; it distills an essential set of related characteristics that are seldom if ever empirically observable in pure form. As an ideal type, we should expect to find in any empirical commons evidence of altruistic motives and behavior; philanthropy; charity; patronage; various forms of donations and gift giving; and programs that involve search, investigation, learning, and other ways of expanding common endowments" (1992, 17-18). "Commons are not places any more than are markets or states" (1992, 62).

¹⁵ So far we have been using *nonprofit* as a catch-all term, as most of the literature does. But it is important to distinguish *nonprofit* organizations from *not-for-profit* firms, which together compose the independent or voluntary sector, in the following way: nonprofit organizations are those that do not typically charge a market price for their services; not-for-profit

organizations are firms that do charge a price for their services (like hospitals), and in principle can therefore calculate the expected and realized monetary "profit" or "residual" of their collective efforts. Cf. Lohmann's appeal to Anthony's distinction between Type A and Type B organizations (Lohmann (1991, 34). Lohmann's "commons" is that sector composed exclusively of nonprofit associations.

¹⁶ See, for example, Boettke (1995a, 1995b), Prychitko (1995b, 1995c), and Boettke and Prychitko (1996). Lohmann's appeal to the role of producer cooperatives (1992, 143) also finds a sympathetic ear with one of us. See, for example, Prychitko and Vanek (1996).

¹⁷ Alchian provides a strong critique of the maximization modeling even of for-profit activity in his classic 1950's paper, one which clearly had an early influence on Boulding (1958) and has inspired more recent work in evolutionary and new institutional economics.

¹⁸ "Since productivity has always been associated with material wealth in the industrial society, many economists question the degree to which services actually generate wealth and are of value to society," laments Bruyn (1991, 324). "The issue, finally, as more and more social scientists are coming to realize, is finding a way to measure social wealth" (1991, 325). We shall suggest that such a measure will be impossible.

¹⁹ See Kirzner's (1976) discussion of the evolution of economic theory, from the science of wealth (as found in Smith and the classicals) to the neoclassical science of economizing and maximizing (with Lionel Robbins, a subject of criticism by Lohmann [1991, 151]), to a more comprehensive theory of human action in general, in the work of Mises and the Austrian School.

²⁰ Smith:

There is one sort of labour which adds to the value of the subject upon which it is bestowed: there is another which has no such effect. The former, as it produces a value, may be called productive; the latter, unproductive labour. Thus the labour of the manufacturer adds, generally, to the value of the materials which he works upon, that of his own maintenance, and of his master's profit. The labour of the menial servant, on the contrary, adds to the value of nothing. Though the manufacturer has his wages advanced to him by his master he, in reality, costs him no expense, the value of those wages being generally restored, together with a profit, in the improved value of the subject upon which his labour is bestowed.

But the maintenance of a menial servant never is restored. A man grows rich by employing a multitude of manufacturers: he grows poor, by maintaining a multitude of menial servants (1937, 314).

The labour of some of the most respectable order in the society is, like that of menial servants, unproductive of any value, and does not fix or realize itself in any permanent subject, or vendible commodity, which endures after that labour is past, and for which an equal quantity of labour could afterwards be procured (1937, 315).

Smith continues by citing “the whole army and navy,...churchmen, lawyers, physicians, men of letters of all kinds,” as well as “players, buffoons, musicians, opera-singers, opera-dancers, etc.”

²¹ Now, there are important incentive issues that can be raised—specifically principal-agent issues—but that is separate from the calculation issue. Our remarks focus solely on whether or not a calculation problem exists in the philanthropic sector. These enterprises earn a profit, which can be calculated, but the profit is not owned by an entrepreneur. They might *make* profit, but the profit is not for any individual in particular.

²² Mises (1981, 159):

Therefore it is absurd to want to apply the elements of this calculation to problems other than those confronting the individual actor [in the market process]. One may not extend them to *res extra commercium*. One may not attempt by means of them to include more than the sphere of the economic in the narrower sense. However, this is precisely what is attempted by those who undertake to ascertain the monetary value of human life, social institutions, national wealth, cultural ideals, or the like, or who enter upon highly sophisticated investigations to determine how exchange ratios of the relatively recent, not to mention the remote, past could be expressed in terms of “our money.”

²³ We use the term “entrepreneur” only in the popular sense of being bold and venturesome here. If our argument is correct, nonprofit managers and foundation leaders *can’t* undertake entrepreneurship in the strictly economic sense of profit-seeking. We wish to suggest only briefly here that they function instead like middlemen in the strict sense. They are “go-betweens,” specialists who have a comparative advantage in reducing the transaction costs among donors and recipients, and it is this middleman function that helps coordinate the commons. This is a topic worthy of further research, which

one of the authors hopes to undertake in a separate paper.

²⁴ See Boettke and Rathbone (2002) for a discussion of the difficulties facing the philanthropic enterprise.

²⁵ As Hayek 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, 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.

REFERENCES

- Alchian, Armen A. 1950. “Uncertainty, Evolution, and Economic Theory,” *Journal of Political Economy* 58: 211-221. Reprinted in Alchian, *Economic Forces at Work*. Indianapolis: Liberty Fund, 1997.
- Berger, Peter L., Richard John Neuhaus, and Michael Novak, eds. 1996. *To Empower People: From State to Civil Society*. Washington, D.C.: AEI Press.
- Boettke, Peter. 1993. *Why Perestroika Failed*. New York: Routledge.
- Boettke, Peter. 1995a. “Individuals and Institutions,” in David L. Prychitko, ed. *Individuals, Institutions, Interpretations: Hermeneutics Applied to Economics*. Brookfield, VT: Avebury: 19-35.
- Boettke, Peter. 1995b. “Interpretive Reasoning and the Study of Social Life,” in David L. Prychitko, ed. *Individuals, Institutions, Interpretations: Hermeneutics Applied to Economics*. Brookfield, VT: Avebury: 59-80.
- Boettke, Peter. 2001. *Calculation and Coordination*. New York: Routledge.
- Boettke, Peter, and David L. Prychitko. 1996. “Mr. Boulding and the Austrians: Boulding’s Contributions to Subjectivist Economics.” In Laurence S. Moss,

- ed., *Joseph Schumpeter: Historian of Economics*. Perspectives on the History of Economic Thought Series. New York: Routledge: 250-59.
- Boettke, Peter, and Ann Rathbone. 2002. "Civil Society, Social Entrepreneurship and Economic Calculation: Toward a Political Economy of the Philanthropic Enterprise." Working paper, Department of Economics, George Mason University.
- Boulding, Kenneth E. 1958. *The Skills of the Economist*. Cleveland: Howard Allen.
- Boulding, Kenneth E. 1966. "The Economics of Knowledge and the Knowledge of Economics." *American Economic Review*, 16 (May): 1-13.
- Boulding, Kenneth E. 1969. "The Grants Economy," *Michigan Academician* (Winter). Reprinted in *Collected Papers of Kenneth Boulding: Vol. II: Economics*. Ed. Fred R. Glahe. Boulder, CO: Colorado Associated University Press, 1971: 177-85.
- Boulding, Kenneth E. 1981. *A Preface to Grants Economics: The Economy of Love and Fear*. New York: Praeger.
- Bruyn, Severyn T. 1991. *A Future for the American Economy: The Social Market*. Stanford, CA: Stanford University Press.
- Buchanan, James M. 1968. *The Demand and Supply of Public Goods*. Chicago: Rand McNally.
- Buchanan, James M. 1975. *The Limits of Liberty*. Chicago: University of Chicago Press.
- Cornuelle, Richard. 1965. *Reclaiming the American Dream*. New York: Random House.
- Glaeser, Edward and Andrei Shleifer. 1998. "Not-for-Profit Entrepreneurs." National Bureau of Economic Research Working Paper 6810.
- Hayek, F. A. 1948. *Individualism and Economic Order*. Chicago: University of Chicago Press.
- Hayek, F. A. 1979. *Law, Legislation and Liberty: The Political Order of a Free People*, Vol. 3. Chicago: University of Chicago Press.
- Heyne, Paul, Peter Boettke, and David Prychitko. 2002. *The Economic Way of Thinking*. 10th ed. Upper Saddle River, NJ: Prentice Hall.
- Hirshleifer, Jack. 1980. *Price Theory and Applications*. 2nd ed. Englewood Cliffs, NJ: Prentice Hall.
- Kirzner, Israel M. 1976. *The Economic Point of View: An Essay in the History of Economic Thought*. 2nd ed. Kansas City: Sheed and Ward.
- Lohmann, Roger A. 1992. *The Commons: New Perspectives on Nonprofit Organizations and Voluntary Action*. San Francisco: Jossey-Bass.
- Machlup, Fritz. 1958. "Equilibrium and Disequilibrium: Misplaced Concreteness and Disguised Politics." *Economic Journal*, LXVIII (March). Reprinted in Machlup, *Essays on Economic Semantics*. Englewood Cliffs, NJ: Prentice Hall, 1963: 43-72.
- Mises, Ludwig von. 1933. *Epistemological Problems of Economics*. Trans. George Reisman. 1933; reprinted New York: New York University Press, 1981.
- Mises, Ludwig von. 1966. *Human Action: A Treatise on Economics*. 3rd rev. ed. Chicago: Regnery.
- Prychitko, David L. 1990. "The Welfare State: What is Left?." *Critical Review*, 4: 619-32.
- Prychitko, David L. (ed.) 1995a. *Individuals, Institutions, Interpretations: Hermeneutics Applied to Economics*. Brookfield, VT: Avebury.
- Prychitko, David L. 1995b. "Introduction: Why Hermeneutics?," in Prychitko (1995a): 1-5.
- Prychitko, David L. 1995c. "Ludwig Lachmann and the Interpretive Turn in Economics: A Critical Inquiry into the Hermeneutics of the Plan," in Prychitko (1995a): 93-112.
- Prychitko, David L. 2002a. "Does Market Socialism have a Future? From Lange and Lerner to Schumpeter and Stiglitz," in Prychitko (2002b): 156-67.
- Prychitko, David L. 2002b. *Markets, Planning, and Democracy: Essays after the Collapse of Communism*. Northampton, MA: Edward Elgar.
- Prychitko, David L., and Jaroslav Vanek (eds.). 1996. *Producer Cooperatives and Labor-Managed Systems Vol. I: Theory and Vol. II: Case Studies*, #62 in the International Library of Critical Writings in Economics, Mark Blaug, series editor. Brookfield, VT and Cheltenham, Gos.: Edward Elgar.
- Salamon, Lester M. 1981. "Rethinking Public Management: Third-Party Government and the Changing Forms of Government Action," *Public Policy* 29 (3): 255-75. Reprinted in Salamon (1995): 17-32. Page numbers refer to 1995 reprint.
- Salamon, Lester M. 1987. "Of Market Failure, Voluntary Failure, and Third-Party Government: Toward a Theory of Government-Nonprofit Relations in the Modern Welfare State," *Journal of Voluntary Action Research* 16 (1-2): 29-49. Reprinted in Salamon (1995): 33-49. Page numbers refer to 1995 reprint.
- Salamon, Lester M. 1989. "The Voluntary Sector and the Future of the Welfare State," *Nonprofit and Voluntary Sector Quarterly* 18 (1): 11-24. Reprinted in Salamon (1995): 203-19. Page numbers refer to 1995 reprint.

- Salamon, Lester M. 1992. "Social Services," in Charles Clotfelder (ed.), *Who Benefits from the Nonprofit Sector?* (Chicago: University of Chicago Press). Reprinted in Salamon (1995): 115-44, as "The Charitable Behavior of the Charitable Sector: The Case of Social Services." Page numbers refer to 1995 reprint.
- Salamon, Lester M. 1993. "The Marketization of Welfare: Changing Nonprofit and For-Profit Roles in the American Welfare State," *Social Service Review* 67 (1): 16-39. Reprinted in Salamon (1995): 220-42. Page numbers refer to 1995 reprint.
- Salamon, Lester M. 1995. *Partners in Public Service: Government-Nonprofit Relations in the Modern Welfare State*. Baltimore: Johns Hopkins University Press.
- Salamon, Lester M. 1999. *America's Nonprofit Sector: A Primer*. Revised edition. New York: Foundation Center.
- Salamon, Lester M. 2002a. "The Resilient Sector: The State of Nonprofit America," chapter 1 of Salamon (2002b), 3-61.
- Salamon, Lester M., (ed.). 2002b. *The State of Nonprofit America*. Washington, D.C.: Brookings Institution Press.
- Salamon, Lester M., and Alan J. Abramson. 1982. *The Federal Budget and The Nonprofit Sector*. Washington, D.C.: The Urban Institute Press.
- Salamon, Lester M., and Helmut K. Anheier (eds.). 1996a. *Defining the Nonprofit Sector: A Cross-National Analysis*. Manchester: Manchester University Press.
- Salamon, Lester M., and Helmut K. Anheier (eds.). 1996b. *The Emerging Nonprofit Sector: An Overview*. Manchester: Manchester University Press.
- Smith, Adam. 1937 [1776]. *An Inquiry into the Nature and Causes of the Wealth of Nations*, edited by Edwin Cannan. New York: Modern Library.
- Smith, David Horton. 2000. *Grassroots Associations*. Thousand Oaks, CA: Sage.
- Stiglitz, Joseph E. 1994. *Whither Socialism?* Cambridge, MA: MIT Press.
- Wagner, Richard E. 1996. *Economic Policy in a Liberal Democracy*. Brookfield, VT: Edward Elgar.
- Weisbrod, Burton A. 1977. *The Voluntary Nonprofit Sector: Economic Theory and Economic Policy*. Lexington, MA: Lexington Press.
- Weisbrod, Burton A. 1988. *The Nonprofit Economy*. Cambridge, MA: Harvard University Press.

COMMENT ON BOETTKE AND PRYCHITKO

Zoltan J. Acs
University of Baltimore

Peter J. Boettke and David L. Prychitko provide a valuable contribution to the debate on the relationship between the compulsory power of the state, the capitalist search for private monetary profit, and the spontaneous ordering of associations—the nonprofit sector. While there is general agreement across the political spectrum that the nonprofit sector plays an important role in American society, the exact nature of that role is in dispute.

Lester Salamon (1999) suggests that the nonprofit sector is not an independent sector but is an effective partner of the state and represents a viable "third party governance." Boettke and Prychitko (emphasis added) argue "that the sort of 'third party government' advocated by Salamon would distort the incentives for nonprofit innovation, and weaken the ability of philanthropists and social entrepreneurs to fill in the gaps that might be left by for-profit firms before government bureaucracies expand to fill the supposed vacuum." Before this Austrian interpretation of the nonprofit sector advocated by Boettke and Prychitko can be properly evaluated, we need to be a little clearer on the relationship between the nonprofit sector and economic development in general and the role of philanthropy in particular.

The word philanthropy literally means "love of mankind." Philanthropic acts manifest the generosity of the giver. In this comment, what we mean by philanthropy is giving money or its equivalent away to persons and institutions outside the family without a definite or immediate *quid pro quo* (Boulding, 1962).

Seeing a linkage between philanthropy and economic development is not new. In *Corruption and the Decline of Rome*, Ramsay MacMullen (1988) discusses how charitable foundations were partly responsible for the flourishing of Rome and how their decline coincided with the loss of the empire. The roots of American philanthropy can be found in England in the period from 1480 to 1660. By the close of the Elizabethan period, "it was generally agreed that all men must somehow be sustained at the level of subsistence" (Jordan, 1961: 401). Though the charitable organizations at the beginning of this period in England were centered around religion and the role of the Church, by the close of the sixteenth century, religious charities comprised only 7 percent of all charities (Jordan, 1961: 402).

How is this philanthropic behavior explained? According to Jordan, there was the partly religious and partly secular sensitivity to human pain and suffering in sixteenth-century England. Doubtless, another important motivating factor was Calvinism, which taught that “the rich man is a trustee for wealth which he disposes for benefit of mankind, as a steward who lies under direct obligation to do Christ’s will” (Jordan, 1961: 406-7).

Beginning with the Puritans, who regarded excessive profit-making as both a crime and a sin (and punished it accordingly), there is a long history of Americans who have questioned the right of people to become rich. In view of the popular prejudice against ostentatious enjoyment of riches, the luxury of doing good was almost the only extravagance the American rich of the first half of the nineteenth century could indulge in with good conscience (Tocqueville, 1966 (1835): 40).

Andrew Carnegie exemplified the ideal Calvinist. Carnegie put philanthropy at the heart of his “gospel of wealth.” For Carnegie, the question was not only, “How to gain wealth?” but also, importantly, “What to do with it?” *The Gospel of Wealth* suggested that millionaires, instead of bequeathing vast fortunes to heirs or making benevolent grants by will, should administer their wealth as a public trust during life (Carnegie, 1889). Both Carnegie (at the time) and Jordan (as a historian) suggest that a key motive for philanthropy is social order and harmony.

Philanthropy remained part of an implicit social contract stipulating that wealth beyond a certain point should revert to society. Individuals are free to accumulate wealth, but the wealth must be invested back into society to expand opportunity. Therefore, much of the new wealth created historically has been given back to the community to build up the great social institutions *that have a positive feedback on future economic development* (Chernow, 1999).

The American model of entrepreneurship and philanthropy in the nineteenth century was followed by a period of progressivism (increasing role of government) in the early years of the twentieth century. Though the period of the 1920s was one of technological change and prosperity, underlying economic problems resulted in the collapse of the world economy into the Great Depression of the 1930s. This period, together with that of World War II, changed the role of the government and the philanthropic activities of the entrepreneur. It is not our point here to argue that the role of philanthropy was to provide social welfare—such as health insurance, social security, and unem-

ployment insurance. Indeed, the rise of the state in the twentieth century was in some ways a rise of social welfare, provided by government.

This function of social welfare, however, is distinct from the pure function of philanthropy that arises from issues of what an individual should do with personal wealth. The rise of the welfare state, with its high marginal taxes, high inheritance taxes, antitrust laws, and the abolition of private property in some societies, tried to eliminate the role of private wealth altogether. In fact, in a socialist state the only role for philanthropy might be religious giving.

What is interesting is that in the United States the rise of the welfare state did not coincide with a decline in philanthropy. In fact, according to a study by the National Bureau of Economic Research (Dickinson, 1970), total private domestic philanthropy as a percentage of U.S. Gross National Product between 1929 and 1959 increased from 1.7 percent to 2.3 percent. This figure is not significantly different from the 2.5 percent that Americans contributed to philanthropic causes in 2003. Why did Americans continue to fund philanthropy at a fairly constant level even as the federal government stepped into the business of social welfare?

One answer was suggested by Soloman Fabricant, and has been echoed by many others (Dickinson, 1970: 8):

...in this broad sense philanthropy is a necessary condition of social existence, and the extent to which it is developed influences an economy’s productiveness. For decent conduct pays large returns to society as a whole, partly in the form of a higher level of national income than would otherwise be possible. Underdeveloped countries are learning that, despite their hurry to reach desired levels of economic efficiency, time must be taken to develop the kind of business ethics, respect for the law, and treatment of strangers that keep a modern industrial society productive. Widening of the concepts of family loyalty and tribal brotherhood to include love of man “in general” is a necessary step in the process of economic development.

The key issue, therefore, in the debate on the role of the nonprofit sector is the *voluntary* nature of the contribution of the donor. As Boettke and Prychitko point out in Salamon’s model “many nonprofits often bypass the responsibility of persuasion and voluntary exchange and instead seek support from the state. In this regard, to accept Salamon’s advocacy of third-party government, which in effect seeks to legitimate nonprofit firms as arms of state

action, would further weaken the effectiveness of nonprofit organizations to promote economic development by encouraging them to engage more in political rent-seeking than in marketplace persuasion.”

What is unique about America is not that it has “an intricate ‘mixed economy’ that blends public and private action in ways that few people truly understand” (Salamon, 1999), but that a crucial component of American economic, political, and social stability rests on the role of philanthropy in American society. The fulcrum of this relationship is between the *private* and the *nonprofit* sectors. What differentiates American capitalism from all other forms of capitalism is its historical focus on both the creation of wealth (entrepreneurship) and the reconstitution of wealth (philanthropy) through an independent nonprofit sector (Acs and Phillips, 2002).

REFERENCES

- Acs, Zoltan J. and Ronnie, J. Phillips. 2002. “Entrepreneurship and Philanthropy in American Capitalism,” *Small Business Economics*, 19, 189-204.
- Boulding, Kenneth. 1962. “Notes on a Theory of Philanthropy,” in Frank G. Dickinson, ed., *Philanthropy and Public Policy*. Boston: NBER, 57-72.
- Bremner, Robert, H. 1960. *American Philanthropy*. Chicago: University of Chicago Press.
- Carnegie, Andrew. 1889. “Wealth,” *North American Review*, (June).
- Chernow, Ron. 1999. *Titan: The Life of John D. Rockefeller Sr.* New York: Vintage.
- Dickinson, Frank, G. 1970. *The Changing Position of Philanthropy in the American Economy*. National Bureau of Economic Research, Distributed by Columbia University Press, New York.
- Jordan, W. K. 1961. “The English Background of Modern Philanthropy.” *The American Historical Review* 66 (2), 401-408.
- MacMullen, Ramsay. 1998. *Corruption and the Decline of Rome*. New Haven: Yale University Press.
- Salamon, Lester M. 1999. *America’s Nonprofit Sector: A Primer*, 2nd ed. New York: The Foundation Center.
- Tocqueville, Alexis de. 1966 (1835). *Democracy in America*. New York: Harper and Row.

COMMENT ON BOETTKE AND PRYCHITKO

Emily Chamlee-Wright
Beloit College

By challenging the condition of Pareto Optimality as the benchmark against which the voluntary sector is compared, Boettke and Prychitko make an important correction in the literature on the philanthropic process. In addition, their analysis of the relationship between the state and the voluntary sector sends a chilling warning. State funding of nonprofit organizations may ultimately erode the voluntary sector’s ability to serve as a check on government power. Further, I agree with the authors that Austrian economics has much to contribute to our understanding of the philanthropic process, and it is on this point that I wish to devote the substance of my commentary.

Specifically, I want to challenge the starkness with which Boettke and Prychitko draw the distinction between profit-seeking firms and nonprofit organizations. By emphasizing the theme of calculation within the Austrian intellectual tradition, the authors focus too little on the Austrian themes of non-price discovery and local knowledge. By developing these themes—themes that both Boettke and Prychitko emphasize elsewhere—I argue that we would go further in advancing our understanding of philanthropic processes.¹

Boettke and Prychitko direct our attention to the Austrian school’s understanding of economic calculation in order to “contribute to the development of an alternative theory of nonprofits.” Nonprofit organizations, the authors argue, are incapable of engaging in economic calculation. Following Mises’ argument regarding the impossibility of rational calculation in the context of a centrally planned economy, Boettke and Prychitko carefully draw the distinction between calculation and measurement:

[Calculation] is not merely measurement as in some input/output flow chart. After all, Soviet planners could measure how much land, labor, fertilizer, tractors, and so on it took to produce a ton of wheat on the collective farms. But they couldn’t calculate the added value of that effort to determine whether they had used those resources efficiently and productively. Lacking market-generated prices, they had no way of solving, with Mises, “the task of allocating [scarce resources] to those employments in which they can render the best service” (1966, p. 207). They couldn’t

determine whether or not their production plans were worth the cost, i.e., whether they generated a positive *net improvement* in wealth...[Central planners] lack the knowledge to plan the economy successfully because they lack the ability to calculate.

Economic calculation affords entrepreneurs the ability to check their expectations against the realized monetary net return for their efforts, and as such provides an essential and meaningful set of signals for how the entrepreneur might revise plans and set a course for future action.

It is not necessary for the entrepreneur to retain the profits earned from an enterprise in order to engage in economic calculation, the authors argue. Not-for-profit organizations, because they charge for their services, are capable of calculating the residual above and beyond the costs of providing those services. Nonprofit organizations, on the other hand, are in an entirely different situation. Because they do not charge for their services, they have no way of engaging in economic calculation. Certainly a nonprofit can make judicious use of monetary prices when counting up its costs, but there is no way to determine through economic calculation whether society is, on net, better off for their efforts.

At this point in the paper, it sounds as though the authors are suggesting that nonprofit organizations are akin to state enterprises in a soviet economy, likely to generate pronounced inefficiencies. But surprisingly, Boettke and Prychitko spare nonprofits from this condemnation. The authors liken decision-making in the nonprofit sector to decision-making within the family, or a decision that preserves a historical landmark, or a piece of great, though non-vendible art. When making decisions in contexts such as these, we know that our “specific goals and efforts are worthwhile,” and for this reason, the nonprofit sector is not systematically prone to failure in efficiency terms.

But this raises the question: *How* do we know this? How do we assess the worthiness of contributing resources to non-vendible objects and services? According to Mises, we know their worthiness directly:

Those things that do not enter into the items of accountancy and calculation are either ends or goods of the first order. No calculation is required to acknowledge them fully and make due allowance to them. All that acting man needs in order to make his choice is to contrast them with the total amount of costs their acquisition or preservation requires. (Mises 1966: 215, cited in Boettke & Prychitko).

On one level, this makes sense. If Bill and Melinda Gates value finding a cure for AIDS and other infectious diseases enough to spend \$1.2 billion on the effort, they will know directly whether such expenditures are worthwhile. Donors in this sense are like consumers—they are the ultimate arbiter of what their philanthropic ventures are worth to them. The Gates family may experience “buyer’s remorse” if the pace of achievement proves too slow for their liking, but the decision itself was nothing less than rational. Further, as Boettke and Prychitko argue, the philanthropic process provides a way for donors like the Gates family to coordinate their plans with the medical research community, and, therefore, it is not systematically prone to failure in terms of efficiency.

But the decision to give to this or that cause represents only one level of the decision-making process in the nonprofit environment. How best to achieve the goals of a nonprofit organization is far more complex than donors directly assessing whether their contributions are worthwhile to them personally. The complexities of decision-making within the operations of a typical nonprofit are significant enough to throw open the door once again to the question of whether the voluntary sector is systematically prone to failure.

An active question within the economic development literature, for example, is whether microfinance organizations in the developing world ought to charge a fee for services such as business training, literacy courses, marketing courses, and the like, if for no other reason than to provide organization managers the meaningful feedback they need to know whether they are offering the right mix of services (see Chamlee-Wright, forthcoming).²

Even when we consider Boettke and Prychitko’s own example of the “family as nonprofit,” the decision-making process seems far more complex than the authors suggest. Boettke and Prychitko offer the following example to show how families, like so many other nonprofit organizations, are able to engage in rational decision-making despite their inability to engage in economic calculation: “Although [parents] cannot *calculate* the value added of their efforts, they can determine whether their specific goals and efforts are worthwhile.” Presumably, parents are able to determine the worthiness of their decisions because they know directly what value they attach to their family’s well-being.

But is it really that simple? In some cases it may be. The parents ask themselves, “Is correcting my child’s overbite worth the \$4,000 in orthodontic care? Yes. Is my child’s desire to wear the latest tennis shoe fashion worth the \$250 price tag? No.” But most of the decision-making that takes place in this non-

profit we call the family is far more complex. We may know directly *that* we value our family's well being, but *how* exactly to achieve our goals is fraught with uncertainty. To instill a sense of confidence in our children, do we encourage them to try a variety of different activities or do we encourage the development of a single talent? Do we choose a home in the city, with all the cultural amenities it has to offer, or do we raise our children in the country where the pace of life is more relaxed? Do we pay for private piano lessons or take a family vacation instead? I agree with Boettke and Prychitko that in this context economic calculation is impossible. But the question of whether rational choice is possible in this non-calculative environment is not resolved simply by saying that we know the worthiness of our decisions directly. Much of the decision-making that takes place in the context of a nonprofit involves the weighing of two (or perhaps many more) alternative courses of action, each of which could be imagined to meet the goals of the organization but none presenting itself as clearly the best alternative a priori. Directors of nonprofits must test their expectations in a process of trial and error. Though discovery will not take the form of economic calculation, they will nonetheless discover.

The problem here is that Boettke and Prychitko draw too stark a distinction between organizations that calculate and those that do not:

[T]here is either calculation or there isn't. There are no "proxies for calculation"—issues of trust, reputation, satisfaction, and so on might serve as effective guides to action, but they cannot serve as sources for calculation itself...Without a priced service, the agents of nonprofit organizations and their donors might engage in "pseudo-calculation," but let's understand that that really means no calculation.

This characterization suggests that economic calculation in the market context is something more than a mere "guide to action." I don't question whether monetary profits and losses are central to the learning process in the market, but the difference between economic calculation and other guides to action is one of degree, not of kind. Market prices and net monetary returns are not "marching orders." Profits tell the entrepreneur that she or he is doing *something* right, but profits do not necessarily signal whether some alternative plan might have generated even more profits. Losses certainly signal the entrepreneur that *something* is wrong, but just what the entrepreneur is supposed to do in response to these losses is a complex interpretive challenge (Ebeling 1986: 45). Indeed, profits and losses are essential guides to action, but they are

guides, not logical directives. As all the possible courses of action and their corresponding outcomes are never laid out before market participants, entrepreneurial decision-making is a process of discovery, not logical deduction (O'Driscoll & Rizzo 1996: 103; see also Hayek 1948). Though monetary calculation is central to market discovery, nonmonetary discovery also takes place as entrepreneurs execute and revise their plans. This dimension of learning within the market seems to be lost in the current discussion.

The authors' stark distinction between calculating and non-calculating organizations also misrepresents the nature of the discovery process that takes place in the voluntary sector. As Boettke and Prychitko argue, in the absence of a priced output, nonprofits cannot engage in economic calculation. Yet, as I have argued, many of the most important choices facing nonprofits are complex enough that decision makers will not be able to discern directly the worthiness of any particular course of action. Does this mean that nonprofit organizations are akin to state-owned enterprises in a soviet-type economy, such that if efforts exerted in the nonprofit sector add (on net) value to society, it will only be by accident?

In that nonprofits cannot rely upon economic calculation, the answer seems to depend on whether directors of nonprofits have access to and can make use of alternative guides to action. Casual observation seems to suggest that many nonprofits have access to a rich source of local knowledge that serves as a meaningful guide to action. A mother looks for cues that her son's involvement in high school sports is contributing to or inhibiting the development of other life skills. The director of a domestic violence center tries to understand the particular reasons some clients return to their abusive spouse and others do not. She may adjust the center's programs in response, and watch to see whether the changes make a difference. Parents and directors of nonprofits may avail themselves of the latest scholarly literature that pertains to their situation, but ultimately it is access to this local (often tacit) knowledge that offers the chance of successful planning and plan revision.

Surely, the guidance such nonmonetary signals provide will not be as clear as the guidance offered by profit and loss calculations, but when we consider that even profit-seeking entrepreneurs need to cultivate nonmonetary guides to action in order to make sense of profit and loss signals, we see that the distance between nonprofit organizations and profit-seeking firms may not be as great as the calculating/non-calculating distinction suggests. A clear distinc-

tion *does* exist, however, between profit-seeking firms—which can make use of both economic calculation and relevant local knowledge—and state-owned enterprises, which are systematically incapable of doing either (see Lavoie 1995). With regard to nonprofits, the question seems to be whether they are capable of cultivating enough relevant local knowledge to serve as an effective guide to action. There is no guarantee that any one particular organization will be able to do this, but there is no systematic reason why we would expect sector-wide failure in this regard, either.

An organization's size, its scope of operations, and its proximity to the people it aims to serve are all potentially important factors in determining its access to relevant local knowledge. But ultimately it is the degree of connectedness, no matter how that might be achieved, that allows the decision maker in the organization to “dwell” in the mind of a person receiving their services. This potential for local knowledge to serve as a cognitive guide in the trial and error process requires further development on both the theoretical and empirical levels of research.

Though the Austrian understanding of economic calculation is indeed an important concept, if we are to understand better the philanthropic process, the Austrian concepts of nonmonetary discovery and the cultivation of local knowledge are equally relevant, if not more so. The inability to engage in economic calculation extends to all nonprofits and therefore does not offer a way to understand why some nonprofits are more successful in achieving their stated goals than others. Nonprofit organizations do differ, however, with regard to their ability to engage in discovery processes of trial and error, and they differ in their access to and ability to make use of relevant local knowledge. Understanding the ways in which nonprofits cultivate and make use of non-price guides to action may go a long way in helping us to understand differences in performance among nonprofit organizations.

NOTES

¹ See, for example, Prychitko's edited volume *Individuals, Institutions, Interpretations: Hermeneutics Applied to Economics*, and Boettke's contribution “Interpretive Reasoning and the Study of Social Life” in the same volume.

² The nonprofit sector may also suffer from perverse incentives as managers

are not rewarded or punished according to the monetary return their decisions earn for the organization, and this can of course lead to significant principal/agents problems as Boettke and Prychitko point out. The current discussion, however, rests on issues of whether nonprofit managers have access to the *knowledge* they require to make rational decisions in the philanthropic process, an issue that remains even if we assume that the interests of the manager match up perfectly with the stated goals of the organization.

REFERENCES

- Boettke, Peter. 1995. “Interpretive Reasoning and the Study of Social Life,” in Prychitko (ed.) (1995): 59-80.
- Chamlee-Wright, Emily. Forthcoming. “Entrepreneurial Response to Bottom-up Development Strategies in Zimbabwe,” *The Review of Austrian Economics*.
- Ebeling, Richard. 1986. “Toward a Hermeneutical Economics: Expectations, Prices, and the Role of Interpretation in a Theory of the Market Process.” In Kirzner, I. (ed.) *Subjectivism, Intelligibility, and Economic Understanding*. New York: New York University Press.
- Hayek, F. A. 1948. “The Use of Knowledge in Society,” in *Individualism and Economic Order*. Chicago: University of Chicago Press.
- O'Driscoll, Gerald and Rizzo, Mario. 1996. *The Economics of Time and Ignorance*. London: Routledge.
- Lavoie, Don. 1995. “The Market as a Procedure for the Discovery and Conveyance of Inarticulate Knowledge,” in Prychitko (ed.) (1995): 115-37.
- Mises, Ludwig von. 1966 *Human Action*. Chicago: Contemporary Books.
- Prychitko, David (ed.). 1995. *Individuals, Institutions, Interpretations: Hermeneutics Applied to Economics*. Brookfield, VT: Avebury.

COMMENT ON BOETTKE AND PRYCHITKO

Roger Lohmann
West Virginia University

I appreciate very much the opportunity to provide written reaction to the Boettke-Prychitko paper “Is an Independent Nonprofit Sector Prone to Failure?” It is one of the most basic rewards of intellectual effort in the crowded contemporary marketplace of ideas to have one’s ideas noticed. Today’s scholarly world of surplus production of papers, articles, and books produces something of a hierarchy of notice: to have one’s work noticed at all is good and more rare than one might otherwise anticipate; to provoke a reaction is even better, and when that reaction is both critically ambitious and favorable, one has perhaps the best reward possible.

In this brief commentary I would like to offer a few additional thoughts in response to specific comments by Boettke and Prychitko on the economic perspective of my book *The Commons*. But first, a bit of background may be appropriate. The book itself is an effort to contribute to a unified theory of nonprofit organization, voluntary action, and philanthropy (Lohmann, 1992). It grew out of an earlier paper entitled “And Lettuce is Nonanimal: Toward An Economics of Voluntary Action” (Lohmann, 1989). The task of theory-building in this area is, inherently, an interdisciplinary one crossing many intellectual limits and boundaries. My principal interest in this topic is summed up well by Richard Cornuelle’s marvelous—and too much ignored—concept of an *independent* sector. As Boettke and Prychitko correctly note, I was (and am) as concerned with the independence of a realm for nonprofit organization, voluntary action, and philanthropy from the marketplace and the household as from the state.

There are many powerful and fundamental disagreements over the coercive powers of the state, the productivity of the marketplace, and the penumbra of privacy for households and families. Regardless of how extensive or limited a role one holds out for states, markets, and households, however, simple logic dictates the existence of an additional social space devoted to activities other than governing, buying and selling, personal intimacy, and procreation and the raising of children.

It is that space, the zone associated by the ancients with such terms as *koinonia*, *philia*, *benefice*, *waqf*, and *kanjin*, to which I was seeking to give name and shape in *The Commons*. The task as I construe it is a fundamentally multidisciplinary one, invoking insights from at least two dozen different

arts, sciences, disciplines, and professions, including art history as well as economics. The sheer scope of the topic so conceived gives us reason to take seriously Boettke and Prychitko’s invocation of Ludwig von Mises’ praxeology. I might be so bold as to suggest that my purpose in *The Commons* was praxeological even before I became aware of the term itself.

Some of the readers of this conversation are committed to the central importance of the idea of philanthropy, for example, with significantly less interest in questions of nonprofit organization or voluntary action. I know from my experience as editor of *Nonprofit Management and Leadership* that the Salamon-Weisbrod “failure theory” perspective—however faulty Boettke and Prychitko find it to be in their paper—is very widely shared. This is especially the case among those researchers, scholars, and students of nonprofit management who find the growth of public purchase of services contracting and the rise of the QUANGO (quasi-nongovernmental organization) to be the centrally important trend of interest within this whole broad area. In part, I took some of the positions I did in the book precisely to refute *the* centrality of this development. My view remains that in some primary, definitional sense, voluntary action and philanthropy in an independent sector are constitutive and paradigmatic of this whole range of activity, even as the QUANGO is largely a matter of marginal and momentary interest.

Thus, I did not in *The Commons* (and still do not) take the rise of a highly visible “sector” of publicly dependent, tax-exempt enterprises to be a development of much intrinsic interest for nonprofit organization, voluntary action, and philanthropy *theory*. In my view, it is a momentary transitioning for entirely political reasons away from the “reluctant welfare state” of the New Deal and Great Society toward something else—what else is not yet altogether clear. In the meantime, public supplicants and retainers are an old and relatively well-understood phenomenon, and the fact that some of them act in the name of organizations and fashion themselves as “nonprofit managers,” “public health” or “social work professionals,” “community arts supporters,” or by some other *nom de guerre* does not in itself lend great theoretical weight to claims that their behavior represents something entirely new and unprecedented.

My claim in the book was rather that contemporary nonprofit, voluntary, and philanthropic developments in the United States were (and are) some of the latest chapters in a much older and more universal set of occurrences leading back through the early Middle Ages in Europe and as far afield as the efforts of the Buddhist emperor-turned-philanthropist Ashoka. The fact that nonmar-

ket, nongovernmental voluntary action and philanthropy have existed for so long and attracted so little attention by social philosophers and theorists (with a few notable exceptions like Tocqueville) is as sad as it is truly remarkable.

With that bit of background in mind, let us turn to a couple of additional points raised in the Boettke and Prychitko paper. Perhaps the crucial assessment of the economics offered in *The Commons* was the following:

Although some of Lohmann's criticisms are generally correct in spirit, his proposed revisions to mainstream economic analysis (such as his attempt to rectify the classical distinction between "productive" and "unproductive" labor) are unfortunate and can be better developed using the insights of Austrian economic theory."

Let me end all suspense here by noting that I have no quarrel with the thrust of this conclusion. I very much appreciate (and agree with) the sympathetic reading Boettke and Prychitko give to the economic portions of my work, published more than a decade ago, and I now believe their correction of my apparent misstep over the Smithian productive/unproductive labor point to be an accurate one. I have no wish to call for a renaissance of classical economics!

The question now for all of us, however, is what are the next steps in advancing a theoretical understanding of the economics of philanthropy? Boettke and Prychitko make a strong (although somewhat preliminary and sketchy) case for an Austrian economics, based on the work of Mises and his praxeology in particular, that ought to be of interest to nonprofit economists and all others (especially noneconomists like myself) interested in philanthropology. Their case for a praxeology becomes even stronger when one moves beyond the single lens of economic theory and acknowledges the essentially multidisciplinary nature of the task. Of course, someone needs to attend—as they do—to the economics of the matter; but others also need to attend—as I sought to do—to the relation between those economics and the social, political, cultural, historical, spiritual, and other aspects of philanthropy. If they do not, we can expect the same old familiar social-science muddles, with economists concluding it really is an economic phenomenon, sociologists that it is a social matter, anthropologists that culture is the key, and each of the assorted representatives of professional, quasi-professional, and other third-sector service providers asserting primacies of their own. In other words, the theory of the third sector will be a varied expression of the very play of narrow self-interests that Boettke and Prychitko and I seek to void. They correctly capture my origi-

nal intent quite accurately in the following: "Lohmann criticizes the failure project for apparently grafting a theory of narrow self-interest and profit-seeking onto a social domain that substantially differs from market activity." A bit later they add, "Lohmann stresses—correctly in our view—that human action in general is not exclusively of the narrowly self-interested variety." These are fundamentally correct readings not only of my words but also of my intentions.

One of the most interesting points for me in the Boettke and Prychitko paper, as those who have read chapter 1 of *The Commons* will recognize, were their comments in defense of economic language. They note that noneconomists often adopt and use terms like *public goods*, *market failure*, and *government failure* "loosely, and erroneously, for the terms have specific meanings." If anything, they understate the matter in their paper. Merely to use terms of art differently than their originators is, of course, one of the most common practices in social science and social theory language use. That in itself is not problematic. The problem arises, as Boettke and Prychitko note, when such terms have very specific meanings and exist within a closely reasoned body of existing theory and the misuses—whether deliberate or not—tend to modify, amend, or in some cases even nullify the original significance of the term. I was convinced when I wrote *The Commons*, as Boettke and Prychitko note, that something like this has happened in the case of these three terms (and others).

Boettke and Prychitko make an even stronger and clearer case than I that this is so. Although they focus this critique on Salamon's writings in particular, I see it more as a general problem of what we might term the nonprofit paradigm—a kind of subculture of understandings (and misunderstandings) that has arisen among a great many writers on nonprofit matters. No one person is solely responsible for the paradigm or for the resulting econobabble it has produced; it is a cousin in many respects of "pop" psychology, perhaps at a slightly higher educational level, being limited as yet to a largely postgraduate audience. Nevertheless, it results from a culture very tolerant of slipshod usage.

Within this scholarly and practical subculture, these three terms as well as others like *efficiency*, *productivity*, and *output* have evolved additional meanings that simply overwhelm the more precise and careful theoretical understandings of economists and all those seeking to attend to careful usage. In this common parlance, *public goods* become simply any products and services that are purveyed by governments or paid for by tax revenues. Such a usage is entirely descriptive and completely voids any possible normative economic connotations

of the more careful, original usage. Another, which I deal with in the book and elsewhere, is the sleight-of-hand substitution (often via concepts of “systems” theory) through which the engineering concept of efficiency as the ratio of input and output replaces the economic concept. This sets up the familiar *reductio ad absurdum* in which that which never happens is always more efficient than anything that does, and the very real practical situation of the present in which any cost reduction can be deemed an improvement in efficiency.

Market failure is likewise often removed from the exact economic context noted by Boettke and Prychitko, and is used as a two-way, all-purpose rationale for nonprofit activity: if goods are provided by some nonprofits somewhere, it must be because a market for them has failed to materialize. If a government subsidy for nonprofits exists, it is similarly treated as evidence of a market failure. In both of these cases, we are dealing more with the sociopolitical dynamics of mission definition and goal displacement than with anything recognizably economic.

This is, of course, most definitely not a process limited to economics or even to philanthropology. The abuse of economic terms in such cases is often largely rhetorical: to harness the power and legitimacy of economic “science” to justify and rationalize noneconomic matters. Economists such as Boettke and Prychitko have every right to insist upon the proper use of economic theory; noneconomists, however, should be equally concerned. Robert Payton’s definition of philanthropy as *private action for the public good*, a formulation originally set forth along lines reminiscent of Cornuelle’s independent sector, has come in for similar rough treatment, as have such terms as *civil society*, *social entrepreneurship*, and the current hands-down favorite for misuse, *social capital*. One of the things I was attempting in *The Commons* was the rather arduous challenge of a noneconomist who strives to use those terms more or less correctly. That I have apparently done so, with the exception noted above, is most gratifying.

One point where I might beg to differ slightly with Boettke and Prychitko is over my intent in using the notion of scarcity. They say that I slip a bit with the concept of surplus. This is less a disagreement over economic meanings than about additional implications. I have no quarrel with their interpretation of the economists’ concept of economic scarcity; it is, as they note, a matter of epistemological positioning rather than empirical fact: life is indeed short, and resources are limited; that choices must be made is simply reality.

My point in *The Commons* was rather a different one, and perhaps by using the economic terms too loosely, I have obscured it: it strikes me still that just as

scarcity in the economic sense exists and must be recognized and dealt with, it is also the case that some rudimentary measure of what I termed the assumption of affluence is necessarily associated with all philanthropic acts. Making any gift requires first having something of value to give, and charitable volunteering or engaging in association with others requires having leisure time available. Moreover, the potential reductionism of the theory of subjective choice is mitigated in this instance by the fact that for something to be truly of value it must be important to both giver and recipient. This makes the determination of philanthropic value inherently a social, rather than a purely individual, judgment. If one has something deemed valuable (advice, let’s say) to give, and no one wishes to receive it, it is not valuable in a philanthropic sense. In this way, the Austrian School points up a fundamental limit on having “a wealth of experience.”

This is all part of what I meant to denote by the assumption of affluence. I agree that it has nothing whatsoever to do with material wealth, even though my examples did, except insofar as material wealth is something both giver and recipient prize. Assuming affluence as a precondition of philanthropic action in this way need not be in any respect inconsistent with the economic concept of scarcity. Indeed, the choice, for example, of whether to invite a friend to accompany you as your guest to a sporting event or to join you in working the noon shift at a soup kitchen is a good expression of the principle of scarcity in operation and also of the assumption of affluence. Economic scarcity dictates that you cannot do both; the interpersonal nature of the determination of philanthropic value dictates that both of you prefer one over the other, and the principle of affluence dictates that the choice makes no sense if the time is not free. “Sorry, but I have to work then” is not simply stating another alternative in the choice; it nullifies the gift situation.

I also appreciate and concur with the authors’ modest appraisal of the role of the theory of value in the overall scheme of philanthropology: “the subjective theory of value cannot help produce overall efficient allocation of philanthropic resources (or of tax-generated resources for welfare). Here, more broad accomplishment of plan fulfillment must suffice in the absence of some more comprehensive yet undefinable and unattainable standard of social optimality.”

In concluding, Boettke and Prychitko write, “With Lohmann, we believe that the nonprofit sector is viable and, we should add, productive.” They then refer back to the unproductive-labor issue already dealt with above, about which I have nothing further to add. They continue: “This leads us back to the

normative issue of whether the commons should be a largely independent sector or whether its ‘partnership’ with the state is a promising development.”

Setting aside current political and ideological questions, there are several things of importance for me in this statement. First, and most importantly perhaps, the recognition on purely economic grounds of genuine economic viability and productivity of nonprofit, voluntary, and philanthropic activity are of the greatest importance. Secondly, Boettke and Prychitko are among the few reviewers and critics of *The Commons* to recognize the centrality of its normative as well as its empirical aspirations. My overall project was not merely to describe and explain, but also to affirm and value nonprofit, voluntary, and philanthropic activity.

I would state the final issue they raise slightly differently, even while agreeing that “a largely independent sector” is a type worth pursuing. For me, the “partnership” between nonprofit corporations and the political state is not a phenomenon that properly belongs within the domain of a nonprofit sector at all, and is most assuredly not a characteristic or definitive activity of a third sector in any meaningful sense. It is, at best, a marginal activity occurring in some vague atheoretical borderland between the third sector and the state, and more probably an activity that belongs entirely within the latter. Close observation of many such organizations over a number of years forces me to the conclusion that those nonprofit organizations that become “partners” of government necessarily also become agents of government; to believe otherwise, that they retain some fundamental independence, is merely wishful thinking. “Partners” they may be, but it is definitely a junior partnership in the most meaningful sense. I agree that deciding whether or not this is a promising development is a question that deserves our closest scrutiny. To do so, however, is a separate issue from the equally important matter of the nature and functioning of a truly independent sector or commons.

REFERENCES

- Lohmann, R. A. 1989. “And Lettuce is Non-Animal: Toward a Positive Economics of Nonprofit Action.” *Nonprofit and Voluntary Sector Quarterly* 18(4): 367-383.
- Lohmann, R. A. 1992. *The Commons: Perspectives on Nonprofit Organization and Voluntary Action*. San Francisco, CA: Jossey-Bass.

COMMENT ON BOETTKE AND PRYCHITKO

Richard Stroup
Montana State University

Boettke and Prychitko undertake a large mission here, especially in the latter portion of their title. In the narrow sense their paper is a critique of the work in this topic area by Lester Salamon, who writes of the failure of the nonprofit sector and calls for more explicit partnerships of nonprofits with government. They make many valid and important points against Salamon’s views along the way. He has, it would appear from their critique, failed to show that the sector has failed, and he fails to show that explicit government-nonprofit partnerships would in fact do better. They do make their case on this, bringing in other elements from the literature in doing so. It is a useful paper.

It is in the second, more ambitious part of the mission declared in their title that they fall short. These two leading Austrian economists, both familiar with the Virginia tradition as well, fail to make many points against Salamon, and bypass many points central to the character of the nonprofit sector, that I would expect an Austrian interpretation (especially one with close ties to George Mason University) to bring sharply into focus. They point out, for example, that a vigorous nonprofit sector can fill in and make government unnecessary in the provision of many community services. (They reference Toqueville but fail to provide a citation which would be most welcome here.) Their point is true and important, but they fail to note the critical fact that government provision is different in kind from voluntary assistance and normally brings very different results, many of them unwanted. As Charles Murray and others have shown, for example, when government steps in to provide welfare payments, the result is, in effect, the purchase of more of the behavior leading to the “need” for welfare in the first place.

Volunteer assistance, by contrast, will typically be local and will normally involve “tough love.” Family, friends, church members, and others providing nonprofit, voluntary assistance are less likely to tolerate the behaviors that lead to poverty—unwillingness to work, use of drugs, promiscuous behavior leading to unwanted pregnancy, and so on. Such assistance is often explicitly limited to “the deserving” when it is private, unlike government-provided welfare paid by involuntary taxpayers. Such providers of voluntary assistance

have local, more intimate knowledge and the tool of shame to work with as well. Government aid is different; it softens the individual's price paid for bad behavior. Bad behavior increases, having in effect been purchased.

The “little platoons” of local clubs, churches, neighborhood groups, and so on, act differently—more holistically, one might say in today's jargon. These groups, described by Murray following Burke's writings much earlier, also form an important part of the social fabric in other areas: once formed to solve one problem, the connections, fellowship, knowledge, and trust gained in one situation are useful in subsequent situations. Individuals understand that joining in is a form of insurance for all. He who does not join in, or who acts in an antisocial manner, will be less well insured. Governmental action tends to displace and destroy the little platoons, making weaker and less resilient the social fabric in the process. Civil society declines, and individual behavior becomes meaner, less civil.

Little platoons of voluntary organizations are different from government in another important way. Government organizations are, we hope, responsive to the electorate in general. A government-supported art gallery must respond to the majority that ultimately rules in a democracy. In a republic, there are mediating forces so that the median voter is not in charge, but still the agency must look to the elected legislature and the elected executives, not primarily to the most passionate gallery-goers. Who pays the piper calls the tune. When taxpayers pay, they have every right to control that for which they pay. “Political interference” is precisely the way the people seek to exercise this right to control their government. If the National Endowment for the Arts is reined in by Senator Jesse Helms for exhibitions of “Piss Christ,” it is because Helms' conservative constituents pay the tab, too, just as do the Endowment's biggest liberal backers. Compare that kerfuffle, and its discordant results, with the results of voluntary nonprofit actions. A private art gallery has every right to bring in—or to reject—any artist its governing body chooses. Those unhappy with their decision need not support the gallery in any way.

A characteristic of private property is that neighbors can get along peaceably, each convinced that the other is wrong and may burn in hell later, but neither causing the other any direct harm or expense. For this reason, private philanthropy, characterized by the voluntary giving of time, talent, or money, is categorically a less disruptive approach to social change than are politically mandated transfers.

It is ironic that voluntary action, with its obvious public good “free rider” problem, will often have less of that very problem than government action taken to replace it. Government can levy taxes and solve the financial free-rider problem, but the social costs can be high. At the cost of peace, perhaps, all can be forced to contribute to the National Endowment for (you name it). But who will control the action so financed? It is here that the public sector has a very serious problem. Good government, in the United States at least, means representative democracy. Will the median voter rule? What legislative or executive branch compromises will be reached? As Gordon Tullock pointed out in a no less prominent place than the *Journal of Political Economy* (1971), public decisions truly are public goods, with no clear private responsibility attached to outcomes. Will public schools be run to benefit the children? Who will successfully fight the teachers' unions and the schools of education for control? No one, as it turns out all too often. Who will see that the military, one answer to the greatest of the classic public goods, the defense of the nation, is controlled for the benefit of all, rather than for the benefit of certain suppliers, certain political districts, and so on?

This free rider problem in government is in fact so severe that we may well end up with less, not more, of the supposed good as a result of government subsidy and the resulting political control. A classic case, again from the *Journal of Political Economy* is religion. Two centuries ago, churches in the United States were mostly state supported. (Only later was the Constitution amended so that states, like the federal government, had to live within constitutional limits in this regard.) The argument for state-sponsored religion was that all citizens gained benefits when anyone was more religious—a religious person was thought to be a better citizen, parent, business person, etc. All gained, so all should support the state church. Indeed this idea holds in most industrial democracies today. Yet in the United States, as the states one-by-one disestablished their churches voluntarily, religion blossomed much further. Church attendance rose, financial support increased in total, the number of preachers increased, and so did religiosity. Why? Presumably, churches run by members only, not at the direction of a majority of voters or their elected representatives, are different churches (or synagogues, mosques, etc.), and thus worthy of much more support—and not coincidentally, control—by those most ardent in the faith. To this day, no other industrial democracy is in a class with the United States in the social importance of religion—because of, not despite, the lack of government support for religion.

No one knows better than an Austrian economist that preferences (not to mention passions) are individual and subjective matters, not even objectively measurable. This acknowledgment of goods being different when produced by different groups, is conspicuous by its absence in the paper under review.

If a little platoon, or a big one for that matter, is run by a committee, then very often it will best be run by a committee of those closest to the problem to be solved or the opportunity to be sought after. Closeness may be defined by geographical proximity, or as in many cases, simply a closely aligned set of passions for the action to be taken. Being joined together in a diverse state, much less a nation, is seldom sufficient for such purposes, yet that is where much of government is financed.

Indeed, most cities are far too large and far too diverse for a city government to effectively run a little platoon or any but the most bland of art galleries, much less a church of any kind. Only when nearly everyone in the city can agree on the action to be taken (murder and theft to be stopped, and courts to enforce such criminal laws, for example) is the political process likely to be reasonably effective and with little added rancor. Yet when ethnic neighborhoods are important and standards of proper behavior vary among them, then even criminal law may need some more local control than the city as a whole can provide. It is not just that voluntary action can reduce the need for government, which Boettke and Prychitko properly point out, but also that government simply cannot truly replace much of what voluntary action can and does accomplish. Salomon is not just wrong: his “partnership with government” approach to voluntary action is too often pernicious as well, when the services sought are important. Government is just not capable of accomplishing much of what we might seek from it, especially in the case of local or specialized services.

A crucial part of voluntary action is the joining together of people holding like goals to get the job done. Others, less intensely involved, will properly have little role to play and correspondingly little voice and little burden to bear. Each goal will be better met when those with the greatest desire for successful action, and thus also probably those most knowledgeable in organizing that action, are in charge. Not being a great fan of ballet, I should logically have no say in how it is done. And when it is done voluntarily, I am sure to avoid polluting the wisdom of zealots who know and care about the subject

far more than I. But if my tax dollars support the ballet, then I have every right to have the same voice as those who know the topic far better because they care far more than I do. The latter is a sad situation all around.

Boettke and Prychitko seem not to note that problem, yet it is crucial to an understanding of what voluntary action means, why it is important, and why voluntary action is diluted and indeed polluted when financial aid is taken from government. In that situation a “partnership” is inevitable, but it is also destructive. It reduces effective coordination, turns passion from production to conflict, and can badly damage the social fabric. The painful lessons shown us by Charles Murray in his writings on welfare and poverty, and the hopeful lesson of Kelly Olds on the privatization in the United States of religion, should not be lost or forgotten as we try better to understand the importance and proper place of the voluntary nonprofit sector.

REFERENCES

- Olds, Kelly. 1994. “Privatizing Religion: Disestablishment in Connecticut and Massachusetts.” *The Journal of Political Economy* 102 (2): 277-297.
- Murray, Charles. 1984. *Losing Ground: American Social Policy: 1950-1980*. New York: Basic Books.
- Tullock, Gordon. 1971. “Public Decisions as Public Goods.” *Journal of Political Economy* 79 (4): 913-18.